

**SMALL BUSINESS FRANCHISING:
AN OVERVIEW OF THE INDUSTRY,
SBA'S ROLE, AND LEGISLATIVE PROPOSALS**

HEARING
BEFORE THE
**COMMITTEE ON SMALL BUSINESS
AND ENTREPRENEURSHIP**
OF THE
UNITED STATES SENATE

ONE HUNDRED SEVENTEENTH CONGRESS

SECOND SESSION

MARCH 16, 2022

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COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP

ONE HUNDRED SEVENTEENTH CONGRESS

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**SMALL BUSINESS FRANCHISING:
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WEDNESDAY, MARCH 16, 2022

UNITED STATES SENATE,
COMMITTEE ON SMALL BUSINESS
AND ENTREPRENEURSHIP,
Washington, DC.

The Committee met, pursuant to notice, at 2:32 p.m., via WebEx in Room 301, Russell Senate Office Building, Hon. Benjamin L. Cardin, Chairman of the Committee, presiding.

Present: Senators Cardin, Cantwell, Booker, Rosen, Hickenlooper, Paul, Scott, Ernst, Young, Hawley, and Marshall.

**OPENING STATEMENT OF HON. BENJAMIN L. CARDIN,
CHAIRMAN, A U.S. SENATOR FROM MARYLAND**

Chairman CARDIN. The Small Business and Entrepreneurship Committee will come to order.

I want to welcome all of our witnesses that are with us today as we take up the franchising business model. I particularly want to welcome our colleague, Senator Catherine Cortez Masto, to the Committee. We will hear from her shortly.

Today's hearing will examine the franchising business model, the small business it creates, the role of the Small Business Administration in helping entrepreneurs open franchises, as well as the Agency's role in protecting entrepreneurs from deceptive marketing and bad actors. I also want to thank Senator Cortez Masto for joining us today to discuss legislation that she has proposed to improve how the SBA supports franchisees.

The most common franchise business model is when a franchisor, usually a large or growing corporation, provides a business system, training, products, and branding to a franchisee, usually an entrepreneur or an established small business, in exchange for a fee and ongoing royalties. The business model is well known and is practiced by some of the largest companies in the world, including McDonald's, Subway, and UPS Store.

When done well, the franchising business model is beneficial for the franchisor, the franchisee, and consumers. Franchisors are able to create efficient and cost effective supply chains while leaving day-to-day operations to the franchisee.

The franchising business model can also be used to fuel the expansion of growing businesses. The franchisee is able to skip the startup phase of a small business, such as conducting market re-

search and product development, by buying an established brand and concept. The franchisee is also able to focus on the daily operations of the business while leaving the marketing, advertising, and supply chain management to the franchisor. The consumer gets predictability and guaranteed quality in the products and services they purchase at locations around the world.

The benefits of the franchising model are many, but the model has its risks, with the disproportionate amount falling on the franchisee. For example, the franchisor is in control of all relevant information a franchisee needs to access the historical performance and financial strength of the franchise to make informed decisions. This information asymmetry inherent in the relationship can lead itself to bad actors.

Recently, I think it was last—a few months ago, Senator Cortez Masto released a report detailing issues in the franchise industry and recommendations for transparency and outcomes for franchisees. As a result, she introduced two bills, S. 1120 and S. 2162. The Small Business Administration Franchise Loan Transparency Act would require the prospective franchise owner to receive accurate historical revenue and store closure information. And the second bill, the SBA Franchise Loan Default Disclosure Act, requires the Small Business Administration to publish default rates for the past decade for each of the franchise brands.

Senator Cortez Masto, we look forward to hearing your explanation of these bills and what brought you to these conclusions, and our Committee is very much looking forward to hearing from you in regards to that legislation.

I also want to welcome the other witnesses that we have on the second panel. I think this can be an extremely important hearing. For many small business owners, franchising has been a path to the middle class and financial security. For many others, opening a franchise has led to a financial ruin. So I am hopeful to learn from all the witnesses about what Congress can do to maintain and improve this successful business model while increasing transparency and protect entrepreneurs chasing the American dream from bad actors and fraudsters.

With that, let me turn it over to Senator Paul for his opening comments.

**OPENING STATEMENT OF HON. RAND PAUL,
A U.S. SENATOR FROM KENTUCKY**

Senator PAUL. After borrowing nearly \$6 trillion in the last 2 years, is any serious person the least bit surprised that inflation has reached a 40-year high, that gas prices are higher than they have ever been, and that supply chain disruptions persist?

You might think that government would change course. You might think that Congress would consider balancing its budget and lowering taxes or repealing burdensome regulations. You might even think that Congress would at least rule out adding more regulatory burdens on small business owners. But you would be wrong. Not one of those things are under consideration today. Instead, demonstrating a remarkable lack of creativity, the legislation under consideration today proposes to solve a problem by spending and regulation with even more spending and regulation.

Unsurprisingly, small business owners believe the economy is on the wrong track. The Job Creator Network's monthly Small Business Optimism Index found that small businesses have grown increasingly pessimistic, increasingly pessimistic every month since July 2021. I am sorry to say that they are not going to feel any better after this hearing.

Today, this Committee focuses on threatening the franchise model, which has often been credited as a business model that spurs job creation, in fact, one of the more successful business models we have. If our goal is to create an environment where small businesses can thrive, our focus should be cutting regulations and barriers to entry. Rather, we are discussing ways to weaken a business model that has been benefiting customers, workers, and entrepreneurs alike across the country, with a great history.

The legislation being discussed today would add more regulations to franchises seeking to obtain SBA loans. The International Franchise Association has stated that these bills attempt to address a problem that does not exist in franchising. Franchisee satisfaction is at an all-time high coming out of the pandemic thanks to the strength of the business model. Adding new government regulations and new government mandates to franchises will, while excluding other types of businesses, arbitrarily pick winners and losers.

I ask for unanimous consent to enter the full statement by the IFA into the record.

Chairman CARDIN. Without objection.
[The information referred to follows:]



MATT HALLER
PRESIDENT and CEO
INTERNATIONAL FRANCHISE ASSOCIATION
WASHINGTON, D.C.

TESTIMONY BEFORE THE U.S. SENATE COMMITTEE ON SMALL BUSINESS & ENTREPRENEURSHIP
HEARING ON "SMALL BUSINESS FRANCHISING: AN OVERVIEW OF THE INDUSTRY, SBA'S ROLE,
AND LEGISLATIVE PROPOSALS."
MARCH 16, 2022

Chairman Cardin, Ranking Member Paul, the International Franchise Association (IFA) appreciates this opportunity to submit its views to the Senate Small Business and Entrepreneurship Committee in connection with the Committee's March 16, 2022 hearings on the topic of "Small Business Franchising: An Overview of the Industry, SBA's Role, and Legislative Proposals."

By way of background, the IFA is the world's oldest and largest organization dedicated to representing and protecting the interests of franchising worldwide. The IFA's members include franchisors, franchisees, and professionals who supply goods and services to the franchise sector of the U.S. economy.

Initially, we note that the IFA takes no position with respect to S. 1120, the proposed "Small Business Administration Franchise Loan Transparency Act of 2021" or regarding S. 2162, the proposed "SBA Franchise Loan Default Disclosure Act." Our comments focus on the issues that the Committee is considering that underpin the proposed legislation.

Recent Franchise Cases.

We understand that among the concerns that the Committee seeks to address are the well-publicized misfortunes of two franchisors in particular – the franchisor of the "BurgerIm" and "Dental Fix" brands. The franchisor of the "BurgerIm" system, for example, has been the subject of enforcement actions by the Federal Trade Commission and the California Attorney General's office. IFA applauds these law enforcement agencies' efforts, which endeavor to investigate and, where needed, bring cases to enforce the law.

We strongly believe that the BurgerIm matter would neither have been prevented nor solved by the proposed legislation. Rather, a proper review of BurgerIm April 2019

franchise disclosure document (FDD) that was submitted to the California regulators would have revealed two key details that should have served as a flashing red light:

First, the franchisor had an especially high rate of franchises that were sold but not yet open. In particular, Item 20 of BurgerIm's FDD revealed that there were 452 sold-but-not-yet-opened franchises, compared with 109 operating at the end of FY18.

Second, the franchisor's financial statements for FY18 – Exhibit "A" within the BurgerIm FDD – revealed that over 98% of its FY18 revenue was derived from initial franchise fees (\$20,401,948), contrasted with a relatively low level of "other" revenue (which included royalties): \$329,926. Because royalties are a byproduct of franchisee operations, the paltry level of royalties exposed the extremely unhealthy nature of the BurgerIm system.

Those two "flashing red lights" should have served as a conspicuous warning to prospective franchisees, their lawyers, auditors, and advisors as well as other interested parties, such as lenders, banks, and even state franchise regulators.

Franchising In General

As noted by FRANData in its recently released 2022 Franchise Outlook, "[f]ranchising helped lead the economic recovery in 2021. By providing advancement opportunities at all levels of the economic ladder, from entry-level to manager and from manager to owner, franchises across America aided not only large-scale reentry into the workforce, but also the possibility of coming back better than ever. The unique business model also put the overall economy on more solid ground, with steady growth on business openings and output contributions. Owing to pent-up demand and strong consumer spending, in 2021 total output generated by franchised establishments improved significantly by 16.3%, to \$787.7 billion.

"Much like the broader GDP growth trend, estimated nominal GDP growth contributed by franchising reached an all-time high of 6.2% in 2021. These figures have real impact, not just in benefitting the U.S. economy overall, but also down to the individual level. Across America, people are turning to franchises to strengthen their own financial outlook.

"Still, headwinds in the current economy will have an impact, with franchise growth in 2022 expected to stabilize. With robust sales growth, new unit development, and job creation, franchising is projected to expand by 2.2%, reaching 792,014 in franchise establishments, which is 17,000 higher than that of 2021. Franchise employment is forecasted to grow at a slightly lower rate of 3.1% to a total of 8.5 million jobs, but it is anticipated to recover to pre-pandemic levels following two years of COVID-era contraction. That is a net gain of almost 257,000 jobs compared to 2021. The output of franchise businesses in nominal dollars is forecast to improve by 4.9% to \$826.6 billion in

2022. Franchises' GDP contribution to the overall economy will remain stable at 3% in 2022, but the growth rate is likely to slow to 5.7%, still higher than the pre-pandemic level, to a total of \$501 billion."

Franchised businesses offer unique opportunities to local entrepreneurs and underrepresented groups at disproportionate rates, especially to minorities, women, and immigrants, with nearly 26% of franchises being owned by people of color, compared to 17% of independent businesses. Franchised businesses generate 2.3 times as many jobs than their non-franchised counterparts, and franchises pay wages that are 2.2 to 3.4% higher than similar non-franchised businesses.¹

Conceptually, a franchised business does not have standards imposed by a franchisor; in fact, it is precisely the opposite: the franchisee chooses and agrees to adopt the standards that a franchisor creates for brand at the outset of the franchise relationship by entering into a mutually agreed-upon contractual relationship. The notion that franchisees are "squeezed" by franchisors and forced into so-called "take it or leave it contracts," as some policymakers have alleged, represents a fundamental flawed understanding of the franchise business model and the free market system itself.

Of course, every business must develop and operate under certain criteria (for example, what time of the day should I open, what items I sell, what quality of products should I offer, where should I buy those items, how should I market my businesses, what prices should I charge, etc.). Rather, the businessperson decides that instead of operating independently – and developing and adopting its own standards – she or he chooses to sign a franchise agreement and join a franchise system precisely in order to take make use of that system's already developed standards. Prospective franchisees take that path because they understand that in order to take advantage of the benefits of being a franchisee, they must accept that the limitations inherent in being part of a system rather than operating on their own. In franchising, you go into business for yourself, but not by yourself.

Indeed, they become franchisees knowing that the limitations serve a valuable propose. For example, not only do the standards help the franchisee developer her or his business, but they also help to preserve the value of those businesses. Undeniably, a wayward franchisee will likely be encouraged to comply with the brand standards for the benefit of all stakeholders – certainly including the "wayward franchisee," but also the franchisor and the other franchisees in the system who have invested in the brand's value. An example of the proposition that standards benefit all the franchisees in the system was cited by the Massachusetts Supreme Judicial Court when it confirmed that a franchisor's post-term covenant against competition was reasonable and enforceable because "Dunkin' Donuts was protecting the very franchise system from which the plaintiff himself benefited." *Boulangier v. Dunkin' Donuts Inc.*, 442 Mass. 635, 636 (2004).

¹ *The Value of Franchising. Oxford Economics (2021).*

The FTC Franchise Rule

The IFA strongly supports the FTC Franchise Rule (16 C.F.R. Part 436) as well as federal and state efforts to enforce the existing laws. The IFA – along with many franchisors and respected professionals working in the franchise sector – submitted comments to the FTC in 2019 in response to the Commission’s request for comments (84 Fed. Reg. 9051 (2019)) on whether the Franchise Rule should be retained. IFA’s detailed comment noted its robust endorsement of the Commission’s retention of the Franchise Rule.

Indeed, the IFA firmly believes that the inherent benefit of useful disclosure and its value to commerce is one of the guiding principles of the American economy. Justice Louis Brandeis famously observed over a century ago that “[s]unlight is said to be the best of disinfectants.” Louis Brandeis, *Other People’s Money and How the Bankers Use It* 62 (1914) (quoted in *Statharos v. New York City Taxi & Limousine Comm’n*, 198 F.3d 317, 323 (2d Cir. 1999)). In considering antitrust issues, the Supreme Court recognized that pre-transaction disclosure of critical life-cycle cost information was invaluable to parties assessing whether to buy the underlying product. *Eastman Kodak Co. v. Image Tech. Servs., Inc.*, 504 U.S. 451, 473 (1992).

The existing Franchise Rule sets up a disclosure regime that has served its fundamental regulatory purpose: to provide significant and important pre-sale disclosure to prospective franchisees.

These well-developed disclosure requirements benefit not only prospective franchisees, but they also provide the basis for an across-the-board industry standard that all franchisors must meet. Disclosure requirements that apply uniformly across the country allow prospective franchisees to compare different franchisors’ offerings and obtain details needed to avoid franchisors that don’t suit the prospective franchisee’s needs, standards, and other requirements. The disclosure also levels the playing field among franchisors so that all are evaluated by prospective franchisees on the basis of roughly the same set of information.

Moreover, the Franchise Rule has become the international gold standard for pre-sale franchise disclosure. Since the Franchise Rule took effect in 1979, dozens of other countries adopted similar requirements, recognizing that pre-sale disclosure similar to that required under the Franchise Rule is needed to protect prospective franchisees and to preserve the integrity of franchisors’ offerings.

State franchise pre-sale registration and disclosure laws, which apply in 14 states, largely parallel the disclosure requirements of the FTC Franchise Rule. These laws also require franchisors to file applications with state regulators to obtain approval before offering franchises in those states. Those state filings are made initially (that is, before the first time the franchisor offers franchises in that state), annually after that (that is, to renew the

initial filing in that state), and in the interim (e.g., if there are material changes to the information in the FDD).

The quality of the U.S. disclosure regime has enabled the growth of legitimate franchised business not only in this country, but internationally as well. U.S. franchisors are highly regarded internationally, and many are sought-after for business development abroad. The fact that the U.S. is a stable and professional environment for franchising is derived, in no small measure, from the professionalism that is required in order to comply with the disclosure obligations under the Franchise Rule.

From IFA's perspective, effective, efficient, and smart law enforcement is necessary to the proper functioning of the disclosure regime and consistent with the goal of making the franchise model more secure, more valuable, and even more beneficial for franchisees and franchisors alike. Encouraging compliance – and where appropriate – penalizing material non-compliance – serves the businesses that are already in franchising. Moreover, a solid and reliable market also serves the needs of the growing number of businesses that seek to adopt this model to efficiently bring their goods and services to the market.

State franchise regulators have a heavy burden due to the growing number of filings by franchisors, limited resources available to the regulatory offices, and the effects of the pandemic. In the case of BurgerIm, state regulators approved the franchisor's FDD even though there were "flashing red lights" as described above. Indeed, many parties (as noted above, these include bankers, lawyers, auditors, and others) also apparently missed those warning signs (although it is impossible to know or quantify how many prospective franchisees saw and heeded those caution flags). (For our own part, we at IFA can also do better – we highlight the accomplishment of fast-growing franchisors and need to redouble our efforts to venerate the franchisors that perform at the highest levels.)

SBA and Franchising

As noted above, the IFA strongly supports the FTC Franchise Rule, and we believe in the disclosure promoted by the Rule. Even as we embrace the inherent value of disclosure, we do not believe that the proposal to require disclosure of SBA loan default rates would have prevented or remedied the problems in the "BurgerIm" system.

Additionally, creating new mandates specifically directed only to franchised businesses – while excluding other types of businesses – unfairly disadvantages a particular business model – especially when the data does not show that franchised businesses experience any discrepancy in SBA charge-offs.

In fact, requiring SBA loan default rate disclosure (leaving aside our doubts as to its value, how dependable would be the underlying data available to franchisors,^{*} and our concerns over other aspects of the proposed legislation) would add another data point to the FDD for franchisees to consider. Notably, the BurgerIm FDD already included more than enough data – the “flashing red lights” referred to earlier – to have alarmed and alerted most prospective franchisees, their advisors, and their bankers as well as state regulators. And yet – despite that clear and clarion disclosure – many parties green lit and even signed on to the BurgerIm franchise arrangements.

Our view is that requiring a special kind of disclosure – for franchisors only – that would add additional data to the FDD would not be useful to prospective franchisees or serve a particularly useful purpose. Furthermore, the appropriate forum to consider changes to franchisor disclosure requirements rests with then Federal Trade Commission, not with the Small Business Administration.

Thank you for the opportunity to share our views with the Committee and for considering the points that we have raised. We would welcome the opportunity to answer any questions that the Senators and their staff may have.

* We also note there are inherent limitations in the reliability and completeness of the data available to franchisors on default rates for SBA-backed bank loans. In order to compile that information, numerous parties would have to provide various pieces of the data puzzle in order to form a complete picture, let alone prepare a reliable and statistically meaningful disclosure. The cost of gathering this data and preparing such disclosure would be far greater than simply downloading an Excel spreadsheet from a network and publishing it in Item 19 of a franchisor’s FDD.

Senator PAUL. In reality, no amount of regulations and disclosures will eliminate the risk in SBA's programs. The best way to avoid risk to taxpayers is to stop forcing them to foot the bill for SBA grants and defaulted loans. As Dr. Yelowitz stated in his written testimony, the SBA's guaranteed lending program cost the taxpayer \$25,000 per job. Another report from MIT found that the PPP program cost the taxpayer \$224,000 per job saved.

Rather than tweaking inefficient and bureaucratic SBA programs, I urge my colleagues to, for once, consider getting out of the way and letting small business flourish. Thank you.

Chairman CARDIN. Before turning to Senator Cortez Masto, I would ask consent that statements from the North American Security Administrators Association and the International Franchise Association be made part of our record. Without objection.

[The information referred to follows:]



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March 14, 2022

Chair Ben Cardin
 U.S. Senate Committee on
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 428A Russell Senate Office Building
 Washington, D.C. 20515

Ranking Member Rand Paul
 U.S. Senate Committee on
 Small Business and Entrepreneurship
 428A Russell Senate Office Building
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Re: NASAA's Core Principles for Evaluating Federal Legislation Relating to Franchises

Dear Chair Cardin and Ranking Member Paul:

On behalf of the North American Securities Administrators Association, Inc. ("NASAA"),¹ I am writing to commend you and your colleagues for scheduling a hearing to examine the franchising industry and the role of the U.S. Small Business Administration ("SBA") in franchising. In addition, I am writing to urge you to consider NASAA's core principles for evaluating federal legislation relating to franchises.

At NASAA, we believe in prioritizing investor protection, encouraging responsible capital formation, and supporting inclusion and innovation in our capital markets. We have ample experience and expertise in the difficult work of maintaining an even playing field in our capital markets for investors and all types of investment products, professionals, practices, and technologies. As you may know, NASAA, the voice of state securities regulators, plays an important role in franchising regulation because many states regulate the offer and sale of franchises and approximately half of them require pre-sale registration of franchise offerings. The insights and opinions of state securities regulators regarding franchises reflect their positions on the frontlines of protecting Main Street investors and engaging with small business owners.²

¹ Organized in 1919, NASAA is the oldest international organization devoted to investor protection. NASAA's membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico, and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grassroots investor protection and responsible capital formation.

² NASAA has several sections, committees, and project groups that carry out and otherwise support its work. Since the 1980s, NASAA has had a group of approximately a dozen state securities regulators that work on various projects and tasks related to franchising. For at least the last 20 years, an employee of the Federal Trade Commission ("FTC") has served as an observer on NASAA's franchise project group. The current chair of the project group is Theresa Leets, Assistant Chief Counsel, Securities Regulation Unit, California Department of Financial Protection and Innovation. Dale Cantone, then-Deputy Securities Commissioner and Chief of the Franchise and Business Opportunities Unit of the Office of the Maryland Attorney General, Securities Division, served as the chair of the project group from 1997 to 2021. To locate NASAA resources relating to franchising, go to [Franchises Resources](#) at nasaa.org. See, e.g., [State Securities Agencies with Jurisdiction Over Franchise and Business Opportunities: NASAA Seeks Public Comment on Proposed Statement of Policy Regarding the Use of Franchise Questionnaires and Acknowledgments](#) (Dec. 7, 2021); [NASAA's Electronic Filing Depository Expands to Franchise Filings](#) (May 3, 2021); [New Franchise Disclosure Handbook Available from NASAA](#) (May 8, 2020); [Informed Investor Advisory: Franchises](#) (Jan. 31, 2011).

President: Melonie Senter Lubin (Maryland)	Secretary: Kevin Hoyt (New Brunswick)	Directors: William Beatty (Washington)
President-Elect: Andrew Hartnett (Iowa)	Treasurer: Claire McHenry (Nebraska)	Marni Gibson (Kentucky)
Past-President: Lisa Hopkins (West Virginia)		Leslie Van Bunkirk (Wisconsin)
Executive Director: Joseph Hradý		Diane Young-Spitzer (Massachusetts)

Like many state securities regulators, we at the Maryland Securities Division have worked hard the last several decades to protect investors in franchises through education, disclosure, and enforcement, among other regulatory tools. At each juncture, we have become more concerned and outspoken about the need for our federal partners to adjust and properly fund their regulatory regime so that it produces enhanced regulatory coordination, investor education, transparency, and enforcement.³

NASAA supports the efforts of the U.S. Senate Committee on Small Business and Entrepreneurship to shine a light on the opportunities for strengthening the franchising regulatory framework in the United States. As you do so, we urge you to consider the core principles outlined below and oppose legislative proposals that are inconsistent with these principles.

- 1. Congress should protect the authority of state securities regulators.** For over a century, state securities regulators have been on the frontlines of work to make our capital markets safer, more efficient, and more inclusive. Today, we continue to work hard to ensure that the latest market practices, including practices in the franchising marketplace, occur within the well-established regulatory framework for supporting investor protection and responsible capital formation in the United States. Those of our members who also regulate the offer and sale of franchises bring an equal measure of commitment to investor protection and sound franchising practices. We oppose federal legislation that preempts or otherwise restricts the authority of state securities regulators, including our administration of state franchise laws.
- 2. Congress should foster better regulatory coordination.** Regulators, particularly state securities regulators and the FTC, communicate about and agree on many issues. However, more can be done to foster better regulatory coordination. *First*, federal entities, including the U.S. Department of the Treasury, the FTC, the U.S. Government Accountability Office, and the SBA, must seek input from state securities regulators on relevant franchise regulatory matters before issuing reports, especially reports to Congress. *Second*, commissions, working groups, task forces, and similar bodies working on franchising and related issues must include representation from state securities regulators. If a member of Congress wanted to act now to promote enhanced regulatory coordination, by way of example, she or he could introduce legislation to amend the enabling statute for the Financial Literacy and Education Commission (“FLEC”) to include representation from NASAA and explicitly include franchise education as an area of emphasis for FLEC.⁴
- 3. Congress should foster easier, more informed decision-making.** Presently, people who want to invest in a franchise face a difficult, time-consuming process for researching opportunities. The average investor, who may be seeking to operate a small business with

³ See, e.g., [Testimony of Dale Cantone](#), Reviewing the Franchise Rule: An FTC Workshop (Nov. 10, 2020); [Prepared Statement of Dale Cantone](#), then-Deputy Securities Commissioner and Chief of the Franchise and Business Opportunities Unit of the Office of the Maryland Attorney General, Securities Division, Before the Subcommittee on Commerce, Trade, and Consumer Protection of the Committee on Energy and Commerce, U.S. House of Representatives (June 25, 2002).

⁴ See 20 U.S.C. Ch. 77, [Financial Literacy and Education Commission](#).

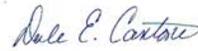
little or no prior business experience, must spend considerable time reviewing the relevant disclosure documents, which typically are lengthy and full of legalese.⁵ In our view, it should not be so time-consuming and hard to invest safely in a franchise. If a member of Congress wanted to act now to foster easier, more informed decision-making, by way of example, she or he could introduce legislation that achieves at least three goals. *First*, the bill would fund an FTC-led effort to explore ways to make franchise disclosure documents easier to read and understand for average franchise investors. *Second*, the bill would direct the FTC to work with NASAA to require that all franchise disclosure documents include meaningful financial performance representation disclosure, wherever feasible. At present, that all-important item of disclosure is not required under the FTC Franchise Rule, even though it is the single most important piece of disclosure that prospective franchise investors desire, and that they should have to make an informed investment decision.⁶ *Third*, the bill would ban the use of waivers. Prospective franchise investors should never be required or asked to waive their rights under applicable franchise laws, nor should they be required or asked to sign a mandatory arbitration agreement.⁷

Thank you for your consideration of NASAA's comments. Should you have any questions, please do not hesitate to contact me or Kristen Hutchens, NASAA's Director of Policy and Government Affairs, and Policy Counsel, at khutchens@nasaa.org.

Sincerely,



Melanie Senter Lubin
NASAA President
Maryland Securities Commissioner



Dale E. Cantone
Senior Assistant Attorney General
Maryland Securities Division

⁵ See [NASAA Comment to FTC Franchise Rule Regulatory Review](#) (May 13, 2019) (calling for the FTC to improve the readability of disclosures) (“Over the last twenty-five years, [the Franchise Disclosure Documents] have become longer and more complicated. According to one noted franchisee lawyer, “[i]t is now not unusual for the entire [FDD], including all related attachments, to exceed 300 pages. In fact, it is not unheard of for a[n] FDD] to exceed 500 pages, or 7.5 pounds, of material.” Some FDDs even exceed 1,000 pages of material.”).

⁶ See FTC, [Transcript: Reviewing the Franchise Rule: An FTC Workshop](#) (Nov. 10, 2020) (participants explained that the present regulatory scheme allows a franchisor to not disclose financial performance representations to prospective franchisees but still make a similar disclosure to banks to facilitate loans).

⁷ See [NASAA Letter to the Leadership of the U.S. Senate Committee on Banking, Housing, and Urban Affairs Regarding Mandatory Arbitration Agreements in Our Capital Markets](#) (Mar. 8, 2022).

Chairman CARDIN. Senator Cortez Masto, I already mentioned the work that you did leading up to the introduction of these two bills. We thank you for your leadership on this issue and so many other issues, and it is a real pleasure to have you before the Committee.

**STATEMENT OF HON. CATHERINE CORTEZ MASTO,
A U.S. SENATOR FROM NEVADA**

Senator Cortez Masto. Chairman Cardin, thank you; Ranking Member Paul and to the distinguished members of the Committee, thank you, for the invitation today to testify about the role the Small Business Administration can play in protecting franchisee borrowers from harmful practices in the franchise industry.

There are terrific franchise corporations out there that provide opportunities for entrepreneurs to own successful businesses, but there are also franchise corporations that treat entrepreneurs incredibly unfairly. Last year, I released a report detailing how the franchise system has left some entrepreneurs financially devastated. I have heard from Nevadans who have lost their retirement funds, their life savings, and their homes trying to repay loans on unprofitable businesses.

Our small business owners do not expect their businesses to be risk-free, but if they purchase a franchise they absolutely deserve to know what they are getting into. Right now, that is not always the case, and the Small Business Administration can do more to fix it.

The SBA is the go-to source of funding for many new franchises. My report indicates that franchise loans make up 13 percent of SBA's total loan portfolio. In 2019 alone, SBA guaranteed more than 7,000 loans to franchise owners. Yet, some franchise brands consistently see high default rates, and the SBA Inspector General has repeatedly raised concerns about these high-risk franchises.

This is why it matters. If a franchise owner gets an SBA loan for a franchise business that is unprofitable, the franchise owner will oftentimes have to repay the loan from personal assets. That is their savings, their retirement funds, and their homes. If those assets are not enough, the SBA then pays off the loan. This is the guarantee that SBA provides lenders that loan to franchise owners. Those repaid funds are paid for by other small borrowers and sometimes taxpayers.

I recommend that the SBA require franchise corporations to share historical financial performance data with the potential franchise owners before the SBA guarantees the loan. It is a simple step that could help investors avoid devastating defaults.

Now I have introduced, as the Chairman said, two bills that ensure franchisee borrowers have access to critical historical financial information that they need before they make a decision to move forward. The SBA Franchise Loan Default Disclosure Act requires the SBA to publish default rates by franchise brand over the past decade. Every lender reports to the SBA monthly on loan performance. The SBA can easily make default rates on loans it guarantees publically accessible on its website. Publishing defaults by brand gives entrepreneurs information about the risks that they might face.

The second bill I introduced, the SBA Franchise Loan Transparency Act, requires franchise corporations to give accurate historical financial performance information to anyone applying for SBA government-backed loans. Now when I talk with franchise owners, they repeatedly tell me that they did the research before investing. Yet, prospective franchise owners are not getting all of the historical financial performance data that they need to make a decision. Any information they get in the franchise disclosure document is required by law to be accurate, but because some franchise corporations know that everything in the FDD has to be accurate they can leave out key pieces of financial performance information. Instead, they may give that information to franchise owners outside the FDD, and they can present it an overly rosy or an inaccurate way. So my bill requires the franchise corporations to provide specific historical performance data in the FDD so that borrowers can make an informed decision about the risks that they face.

People buy franchises because they want to invest in a business that has proven successful. You are going to hear that today from one of your panelists. Only brands willing to share revenue data on how their franchises have performed in the past should earn the privilege of having their investors receive SBA guaranteed loans. In that sense, my bills sets a standard for franchise corporations.

Now although I have introduced bills to make these changes, let me make it very clear that the Small Business Administration has the power to take these steps on its own. And so while franchises are wonderful business opportunities for hardworking Nevadans and they are wonderful business opportunities across the country, we need to do more to ensure that all franchise owners have that experience. The SBA should not be guaranteeing high risk loans.

So I want to thank the Committee for taking this subject up. I look forward to working with the various members of the Committee and the Chair and Ranking Member and thank you again for holding this hearing.

[The prepared statement of Senator Cortez Masto follows:]

Statement of Senator Catherine Cortez Masto
before the
**Senate Small Business Committee: Small Business Franchising: An Overview of
the Industry, SBA's Role, and Legislative Proposals**
March 16, 2022

Chairman Cardin, Ranking Member Paul, and distinguished members of the committee:

Thank you for inviting me to testify about the role the Small Business Administration can play in protecting franchisee borrowers from harmful practices in the franchise industry.

There are terrific franchise corporations out there that provide opportunities for entrepreneurs to own successful businesses. But there are also franchise corporations that treat entrepreneurs incredibly unfairly.

Last year, I released a report detailing how the franchise system has left some entrepreneurs financially devastated. I've heard from Nevadans who have lost their retirement funds, their life savings, and their homes trying to repay loans on unprofitable businesses.

Our small business owners don't expect their businesses to be risk-free. But if they purchase a franchise, they absolutely deserve to know what they're getting into. Right now, that's not always the case, and the Small Business Administration can do more to fix it.

The SBA is the go-to source of funding for many new franchises.

My report indicates that franchise loans make up 13% of the SBA's total loan portfolio.

In 2019 alone, SBA guaranteed more than 7,000 loans to franchise owners.

Yet some franchise brands consistently see high rates of default. And the SBA Inspector General has repeatedly raised concerns about these high-risk franchises.

This is why it matters: Franchise owners often sign a personal promissory note. If they can't pay the loan from profits from the business, they will be on the hook for repaying the loan from their savings, their retirement funds, or their homes.

If those assets are not enough, the SBA will pay off the loan. Those repaid funds are paid for by other small business borrowers, and sometimes, the taxpayers.

I recommend that the SBA require franchise corporations to share historical financial performance data with the potential franchise owners before the SBA guarantees a loan. It's a simple step that could help investors avoid devastating defaults.

I've introduced two bills that ensure franchisee borrowers have access to critical historical financial information they need.

The *SBA Franchise Loan Default Disclosure Act* requires the SBA to publish default rates by franchise brand over the past decade.

This is simple: Every lender reports to the SBA monthly on loan performance. The SBA can easily make default rates on loans it guarantees publicly accessible on its website. Publishing defaults by brand gives entrepreneurs information about the risks they might face.

The second bill, *the SBA Franchise Loan Transparency Act*, requires franchise corporations to give accurate historical financial performance information to anyone applying for SBA government-backed loans.

When I talk with franchise owners, they repeatedly tell me that they did their research before investing. Yet prospective franchise owners are not getting all the historical financial performance data they need. Any information they get in the Franchise Disclosure Document is required by law to be accurate.

But because franchise corporations know that everything in the FDD has to be accurate by law, some of them intentionally leave out key pieces of financial performance information. Instead, they will give that information to franchise owners *outside* the FDD—where they can present it in an overly rosy or inaccurate way.

My bill requires the franchise corporations to provide specific historical performance data in the FDD, so that borrowers can make an informed decision about the risks they face.

People buy franchises because they want to invest in a business that's proven successful. Only brands willing to share revenue data on how their franchises have performed in the past should earn the privilege of having their investors receive SBA-guaranteed loans. In that sense, my bill sets a standard for franchise corporations.

Although I've introduced bills to make these changes, the Small Business Administration has the power to take these steps on its own.

Many franchises are wonderful business opportunities for hardworking Nevadans. We need to do more to ensure that all franchise owners have that experience. The SBA should not be guaranteeing high-risk loans.

I'll continue to work with the members of this committee to make much-needed changes that protect hardworking franchise owners. Thank you.

Chairman CARDIN. Well, Senator, thank you for your work on this area and also for your testimony here today. It is hard to generalize. I agree that franchises are an extremely important part of entrepreneurship and it has been a very successful model, business model. It seems to me that the requirements in your two bills—if we were to categorize those franchises that have been most successful, they comply with those requirements. They are already making that information available to potential franchisees.

So it seems to me what your bill is doing is establishing best practices in the field in an effort to make sure that the concept of franchising maintains a standard that will allow it to grow in the future. So I applaud you and the legislation.

Are there any questions by members of the Committee for Senator Cortez Masto?

[No audible response.]

Chairman CARDIN. If not, thank you very much for your testimony. Appreciate it.

Senator Cortez Masto. Thank you.

Chairman CARDIN. We will now go to our second panel. We have testifying virtually, Professor Robert Emerson, and he is the Huber Hurst Professor of Business Law at the University of Florida. He has authored several business law textbooks and written several dozen law journal articles, book chapters, and other works on franchise law. He has led research symposia on franchising and taught franchise and distribution law at universities and institutions throughout North America and Europe.

We will then hear from Aaron Yelowitz. Dr. Aaron Yelowitz is a professor in the Department of Economics at the University of Kentucky, a senior fellow with the Cato Institute, and a research fellow with the Institute of Labor Economics. He has taught graduate classes in public economics and health economics and undergraduate classes on health economics, labor economics, housing economics, and poverty and welfare programs.

We will then hear from Leanne Stapf, Chief Operating Officer of The Cleaning Authority, Columbia, Maryland. Leanne Stapf has been the Chief Operating Officer of The Cleaning Authority since 2012, working to build and enhance the infrastructure to support franchisees. She is also a franchisee of a location of The Cleaning Authority in Harrisburg, Pennsylvania. The company's franchises provide regular cleaning services to over 100,000 customers.

Now lastly, we will hear from Mr. Bryan Tipton, owner of Tipton Investments in Nicholasville, Kentucky. He has been an Arby's franchisee since 2008 and also owns a residential rental company. Mr. Tipton works in the operations of his restaurant. Mr. Tipton grew up in Richmond, Kentucky, working in the fast food industry and attended Eastern Kentucky University before pursuing restaurant management.

We will start first with Professor Emerson, virtually.

I would ask each of you to—your full statements will be made part of our record. If you could summarize in about five minutes, we would appreciate that.

Professor Emerson.

STATEMENT OF ROBERT W. EMERSON, HUBER HURST PROFESSOR OF BUSINESS LAW, UNIVERSITY OF FLORIDA, GAINESVILLE, FL

Mr. EMERSON. Thank you. Chairman Cardin, Ranking Member Paul, distinguished Committee members, I am honored to be invited to this hearing. I grew up not far from the Capitol in Silver Spring and wish I could be there in person.

This morning, I watched the incredibly moving speech before Congress of President Zelenskyy, and I will be the first person to acknowledge that my thoughts on franchising obviously do not matter much compared to something as epic as that. Still, as I thought about Ukraine's heroic fight for freedom and democracy, I thought about how franchising is a kind of marketplace democracy.

As a model for business based on free choice, good governance, transparency, and a certain measure of democratic norms, much should be expected of franchising, and the best run franchisors generally do quite well, yet not at the expense of franchisees. They are really all in it together.

Many franchisees have benefited very much from becoming part of a franchise network family, but other franchisees have been hurt tremendously. To some degree, these franchisees can, and no doubt often do, blame themselves for not steering away from what turned out to be a fateful choice to purchase a franchise, but those mistakes are so predictable. Just as we do not know who exactly will be injured due to poor designs or manufacturing but we can predict that there will be significant numbers who are injured, so we can look at how some franchise systems operate and how some franchise prospects will proceed, and it all so predictable that people will be hurt.

So there are norms in that franchisees should have a number of freedoms that a written term in a FDD or a franchise agreement cannot deny, freedoms such as to go to court to assert a claim based directly on the FTC rule, to freely associate and exchange information with other franchisees without any fear of retaliation, to be able to introduce in court the statements made to them by franchisor representatives despite a parol evidence rule or waivers or nonreliance defenses.

A norm of good franchise system governance should be that franchisors are bound by the reasonable expectations of all the parties concerned, including franchisees, whenever operations manuals may be used or require expensive changes to the system.

Perhaps most of all, and this is really more on regulators and the franchising community as a whole, the mountain of information that is available to prospective franchisees needs to be more readily accessible, in a highly useful format, for easy tabulation and comparison of FDD data from various franchisors or even across industries.

In my research, I have gathered hundreds of FDDs and put them in somewhat surgical files for my use. But when you need to put in time to do that, well, it really does help to have tenure. Prospective franchisees do not have that time and may understandably feel as if they are being hosed down by a fire hydrant of documents, disclosures, and disclaimers. Exhaustion, information overload may

lead them to decide to abstain from some choices that they really should make.

So I do endorse S. 1120 and certainly agree with the motives behind S. 2162, but the FTC, the SBA, the NASAA, the IFA, and probably some other acronyms certainly could work to make the data much more user-friendly. That would be good for everyone.

The data out there is really a set of collective experiences, and when we look at those experiences, you could say that franchise systems are all feeding off of experience, what a franchise network builds upon. There is always more for us to learn, and thus, I hope I am one person for whom the old quip does not apply: You can always tell a Harvard man, but you cannot tell him much.

[The prepared statement of Mr. Emerson follows:]

Robert W. Emerson
Huber Hurst Professor of Business Law
Warrington College of Business
University of Florida

Written Statement for Hearing, “Small Business Franchising: An Overview of the Industry, SBA’s Role, and Legislative Proposals,” March 16, 2022, U.S. Senate Committee on Small Business and Entrepreneurship

Chairman Cardin, Ranking Member Paul, and distinguished members of the Committee, thank you for inviting me to testify at this hearing. Franchising has been the focus of most of my research as a professor of business law for 34 years. My vita and short bio provide more information about my background as an attorney and educator, including – of greatest relevance – my work related to U.S. and international franchise law. Besides writing several dozen law journal articles and some book chapters on a variety of franchise law topics, my work in franchise law has extended to occasional stints as an expert, to membership in the American Bar Association’s Forum on Franchising and in a multidisciplinary academic organization, the International Society of Franchising, and to occasional teaching of franchise and distribution law at universities both here and abroad.

I very much appreciate the opportunity to “testify” some with this writing, as I know the Committee’s time is quite valuable and oral testimony is necessarily limited in both time and scope. Even for this theoretically unlimited written statement, I will try to overcome the fact that I am “doubly blessed” (both a lawyer *and* a professor), and endeavor to keep things relatively brief.

An Overview of the Franchising Business Model

The franchise business model is a widely used arrangement that permits businesses to expand quickly and inexpensively into various markets both domestically and internationally.¹ For example, in the United States, franchised businesses account for roughly 40% of all retail sales,² with over 780,000 operating franchised units directly employing about 8.3 million people

B.A., Sewanee: The University of the South (1978); J.D., Harvard Law School (1982). Member of the Maryland Bar since 1982. The opinions expressed in this Written Statement are those of the author, and are not necessarily those of the University of Florida, the Warrington College of Business, my various coauthors, or institutions with which I am affiliated. My email address is robert.emerson@warrington.ufl.edu.

¹ The American concept of franchising is expanding rapidly throughout the world, with an increasing share of international commerce. See Robert W. Emerson, *Franchise Encroachment*, 47 AM. BUS. L.J. 191, 196–97 n.23 (2010) (detailing the numerous statistics indicating the phenomenal growth of franchising worldwide, both throughout Europe and such diverse and important national economies as those of Australia, Brazil, China, India, and Japan). That growth has expanded to the developing world. It is believed that this growth, in various markets worldwide, both mature and developing, is driven both by the attraction of franchising for domestic brands and also for foreign-based brands seeking to expand outside of their saturated “home” territories.

² This is an estimate long touted by various sources. At the very least, franchising’s share of the total retail economy, since at least the year 2001, has been one-third. ROGER D. BLAIR & FRANCINE LAFONTAINE, *THE ECONOMICS OF FRANCHISING* 26-27 n.28 (2005); Emerson, *supra* note 1, at 196-197. For earlier statistics, see U.S. DEP’T OF COMMERCE MINORITY BUS. DEV. AGENCY, *FRANCHISE OPPORTUNITIES HANDBOOK* vii (1995); Robert W. Emerson, *Franchising Covenants Against Competition*, 80 IOWA L. REV. 1049, 1050-51 n.4

and indirectly accounting for close to twice that many jobs.³ Furthermore, these franchised businesses create an economic output of \$1.6 trillion dollars and account for 5.8% of the U.S. GDP.⁴

Franchising provides a method for businesses to expand quickly and inexpensively into various markets. A business [the franchisor] accomplishes this task by licensing its name and trademark as well as selling its goods or its particular business format to independent franchisees in exchange for payment of a royalty. The franchisee also benefits from such an arrangement. By entering into a franchising relationship, a franchisee can effectively run its own business without having to invest substantial time and money trying to perfect a new good or business method. That is, franchisees benefit from their franchisor's knowledge, experience, research, development, capital, and reputation.⁵

Essentially, franchising allows the franchisee to effectively run its own business without having to invest substantial time and money trying to perfect a new product or business model.⁶ Typically, franchisees own and operate a business “in accordance with conditions and procedures prescribed by the franchisor, who in turn advertises, advises, perhaps lends capital, and/or otherwise assists the franchisees. The franchise network generally consists of a system-wide marketing plan and/or a ‘community of interest’ between the franchisor and its franchisees.”⁷

As with many things in life, the experience and perspective of the parties to a franchise contract can vary tremendously; some franchisees remain quite happy or at least content with their investment decision, while others in time are filled with regret. Of course, in business relationships (and a franchise is, in essence, a business *relationship*), the parties' level of satisfaction, or not, is likely to have a strong correlation to the profitability, or not, of their dealings.

(1995) (citing numerous sources concerning the rapid growth of franchising in both the 1980s and the early 1990s).

³ David L. Steinberg, *Franchise Industry Facts*, <https://franchiselawyer.com/franchise-legal-resources/franchise-industry-facts> (citing INTERNATIONAL FRANCHISE ASSOCIATION).

⁴ *A Look at How Franchises Impact the Economy*, FRANCHISE DIRECT (January 28, 2020), <https://www.franchisedirect.com/information/a-look-at-how-franchises-impact-the-economy>.

⁵ Robert W. Emerson, *Franchise Contract Interpretation: A Two-Standard Approach*, 2013 MICH. ST. L. REV. 641, 641-642 (2013). See generally Int'l Franchise Ass'n, What Are the Advantages and Disadvantages of Owning a Franchise?, FRANCHISE.ORG, <https://www.franchise.org/faqs/basics/what-are-the-advantages-and-disadvantages> (last visited March 14, 2022); BLAIR & LAFONTAINE, *supra* note 2, at 9-13; ELIZABETH CRAWFORD SPENCER, THE REGULATION OF FRANCHISING IN THE NEW GLOBAL ECONOMY, 7-9 (2010). A study of 100 randomly selected fast food franchises found the median initial franchising fee to be \$25,000. In the same study, the median royalty payment was 5% of revenue. Emerson, *supra* note 5, at 689.

⁶ Robert W. Emerson & Uri Benoliel, *Are Franchisees Well-Informed? Revisiting the Debate over Franchise Relationship Laws*, 76 ALB. L. REV. 193, 203 (2012/2013).

⁷ ROBERT W. EMERSON, BUSINESS LAW 348 (Barron's Educ. Series, Inc., 6th ed. 2015).

Although many commentators believe there is a higher survival rate for franchised businesses than for new, independent businesses, there are, compared with completely independent operations, many additional costs associated with franchising, such as initial fees and continuing charges (royalties). Thus, a bottom-line question for a prospective franchisee is this: ‘What can the franchisor do for me that I cannot do for myself?’ Only if the services, trademarks, goods, and other items obtained from the franchisor cannot be lawfully produced on one’s own, and only if they are truly of long-term economic worth, should one pay the franchisor to join its network as a franchisee.⁸

The right match of franchisor and franchisee can produce a long, mutually beneficial arrangement for both parties: franchisors receive the franchisees’ money and efforts, spread some of the risk of loss to the franchisees, and obtain – at lower cost and perhaps higher efficiency – an expanding sales or services network, while franchisees “can start a business despite limited capital and experience” as well as benefit from the franchisor’s business expertise and the goodwill of the franchise product or trade name (the brand).⁹ Some other advantages for the franchisee are equally well-known:

‘Owning a franchise allows you to go into business for yourself, but not by yourself.’ A franchise provides franchisees (an individual owner/operator) with a certain level of independence where they can operate their business . . . [and perhaps benefit from] a pre-sold customer base which would ordinarily takes years to establish. A franchise increases your chances of business success because you are associating with proven products and methods[, perhaps attracting customers due to a system-wide, contractually-mandated] level of quality and consistency.¹⁰

A prospective franchisee should attend to the sometimes severe, often numerous disadvantages of franchising that may outweigh the benefits. Due diligence and the counsel of professionals (lawyers, accountants, etc.) are certainly highly recommended,¹¹ something that

⁸ *Id.*

⁹ *Id.* at 348-349. The franchisor’s “business expertise” may constitute “support” for the franchisee: pre-opening (e.g., site selection, design, construction, finance, and training) and ongoing (e.g., training, advertising, operating procedures, assistance and supervision, increased spending power, and potential bulk purchasing). INT’L FRANCHISE ASS’N, WHAT ARE THE ADVANTAGES AND DISADVANTAGES OF OWNING A FRANCHISE? <https://www.franchise.org/faqs/basics/what-are-the-advantages-and-disadvantages> (last visited March 14, 2022).

¹⁰ INT’L FRANCHISE ASS’N, *supra* note 9.

¹¹ Robert W. Emerson, *Fortune Favors the Franchisor: Survey and Analysis of the Franchisee’s Decision Whether to Hire Counsel*, 51 SAN DIEGO L. REV. 709, 723–24 (2014) (citing franchisor lawyers and other franchise law commentators to note the likelihood that unrepresented franchisees will not understand their complex franchise agreements). See also Robert W. Emerson, *Transparency in Franchising*, 2021 COLUM. BUS. L. REV. 172, 219-223 (2021) (discussing how potential franchisees sometimes opt for franchise law advice and related guidance from online services, particularly LegalZoom, including the charges for these services as well as the problems with and litigation against LegalZoom and other online providers of documents and legal assistance).

franchisors should encourage, perhaps via a new requirement in the FTC Rule.¹² Of course, retaining a lawyer is not required. And – in fact- many prospective franchisees do not obtain the professional advice that they need.¹³

The disadvantages of franchising need to be as well-understood as the advantages. These actual or at least potential serious problems with franchising should be contemplated by franchise applicants, who should receive the advice of counsel, hopefully well before a franchise applicant might be bound to a “bargain”:

The franchisee is not completely independent. Franchisees are required to operate their businesses according to the procedures and restrictions set forth by the franchisor in the franchisee agreement. These restrictions usually include the products or services which can be offered, pricing and geographic territory. For some people, this is the most serious disadvantage to becoming a franchisee. In addition to the initial franchise fee, franchisees must pay ongoing royalties and advertising fees. Franchisees must

¹² There are certain disclosures or warnings that could be put more starkly, in hopes of really capturing the prospective franchisee’s attention. I recommend such measures in order to counter the tendency of a large percentage of people who, whether actively or passively, refrain from hiring counsel before signing a franchise agreement.

[I]t may be argued that the best method for dealing with uncounseled franchisees, in conformity with a regulatory framework suitable to providing additional protections, is to require more from the franchisor, such as disclosing more information to prospective franchisees about the importance of seeking independent counsel. New disclosures could take the form of an acknowledgement that the franchisee is fully aware of the potential issues that could arise from not seeking counsel in the franchise negotiation process and the signing of the agreement. The acknowledgement need not constitute the waiver of a franchisee’s right to sue the franchisor for misrepresentations or otherwise but should emphasize the need to have lawyers review the documents and thereby negate the current impact of uncounseled franchisees on franchised networks and the courts. The notice would explicitly remind would-be franchisees that what they are about to sign merits the expert guidance of a franchise attorney. For example, the warning could say:

Before agreeing to become a franchisee, you should consult with an experienced franchise lawyer. As a practical matter, including a long-term savings of time and money, your hiring that lawyer at the outset is almost always a ‘must.’

Do not trust in your ability, or the ability of others, to decide whether you need a lawyer’s assistance for something this important. Just as a new but persistent physical ailment should lead you, as a matter of personal health, to do more than just treat it yourself but to see a medical doctor, so you, when buying a franchise, should not ‘go it alone.’ To proceed without a lawyer, you simply do not know enough about this franchise, the legal nature of the franchise documents, and the many relevant laws.

The nature of professional expertise (medicine, law, etc.) is that even an otherwise very smart and experienced individual, if not a professional in that field, needs professional assistance. Also, your lack of training and experience in law likely makes you unable to assess whether and how a legal expert (a franchise lawyer) could help you. So, no matter how smart or experienced you may be generally or even for this particular type of business, you probably cannot accurately weigh the costs of ‘going it alone’ versus paying for legal counsel. Very often in hindsight, a franchisee who failed to hire a lawyer deeply regrets that he or she did not hire a lawyer at the outset.

If properly formulated and distributed, such a warning could operate quite well. Franchisees would not just be better advised; the result would include the beneficial side effects of fairer franchise agreements and reduced litigation.

Emerson, *Fortune Favors the Franchisor*, *supra* note 11, at 769-770.

¹³ See Emerson, *Fortune Favors the Franchisor*, *supra* note 11, at 715 & n.29, 718 (noting that franchisors often recommend that franchisees seek counsel but also that, at closings, counsel represented only 26.07% of franchisees).

be careful to balance restrictions and support provided by the franchisor with their own ability to manage their business. A damaged, system-wide image can result if other franchisees are performing poorly or the franchisor runs into an unforeseen problem. The term (duration) of a franchise agreement is usually limited and the franchisee may have little or no say about the terms of a termination.¹⁴

Indeed, other areas of franchise law likewise may be viewed as, in their effects, imploring franchisors to try to ensure that a little bit of disclosure does not relieve franchisees and their advisors from reading, retaining and reflecting upon what is in a disclosure. For example, as noted in Senator Cortez Masto's April 2021 Report, "seeing a brand listed in the Small Business Administration Franchise Directory, provides a sense of legitimacy, which can lead to undue belief in the viability of the brand."¹⁵ There are, of course, many other matters to consider.

Many Non-Disclosure Reforms Are Possible in Franchising

There are a number of reforms, either legislative or in regulations, that would clarify the franchise law, make it more uniform, or simply rectify an imbalance that disfavors the franchisee. Among these proposals are the following:

1. There should be a private right of action with respect to violations of the FTC Franchise Rule.
2. As found in about ten states, a franchisee right of association should be guaranteed either uniformly (in all of the states) or via a national law.¹⁶ Note that the proposed law would not necessarily grant to franchisee groups (e.g., associations or advisory councils) the right to compel the franchisor to engage in collective bargaining with an association. Instead, the reform would be a Norris-LaGuardia Act equivalent: franchisees having the right to join an association without fear of an actual discharge, a constructive discharge, or some other discriminatory behavior.
3. Absent a compelling reason, arbitration clauses should not be enforced against a franchise party that wants to sue or defend a case in court.

¹⁴ INT'L FRANCHISE ASS'N, *supra* note 9.

¹⁵ OFFICE OF SENATOR CORTEZ MASTO, STRATEGIES TO IMPROVE THE FRANCHISE MODEL: PREVENTING UNFAIR AND DECEPTIVE FRANCHISE PRACTICES 11 (April 2021) (hereinafter, "STRATEGIES TO IMPROVE THE FRANCHISE MODEL").

¹⁶ Even when franchisees may recognize the usefulness of acting collectively and supporting one another, that recognition is unlikely to produce any action that overturns any strongly pro-franchisor power imbalance. See Robert W. Emerson, *Franchising and the Collective Rights of Franchisees*, 43 VAND. L. REV. 1503, 1556-1566 (1990) (arguing for the need for state right of association laws and federal antitrust law reforms bolstering the franchisees' right to act collectively); Robert W. Emerson & Uri Benoliel, *Can Franchisee Associations Serve as a Substitute for Franchisee Protection Laws?*, 118 PENN ST. L. REV. 99, 104, 119-128 (2013) (concluding that for many reasons of law, psychology, and economics, franchisees are unlikely to avail themselves of opportunities to form or join franchisee associations); Warren S. Grimes, *The Sherman Act's Unintended Bias Against Lilliputians: Small Players' Collective Action as a Counter to Relational Market Power*, 69 ANTITRUST L.J. 195 (2001) (noting that antitrust law unfairly disfavors franchisees and other smaller businesses); Warren S. Grimes, *Market Definition in Franchise Antitrust Claims: Relational Market Power and the Franchisor's Conflict of Interest*, 67 ANTITRUST L.J. 243 (1999) (noting that franchisees and franchisors have differing interests often of great importance when parties turn to, or defend against, antitrust claims).

4. A number of persons working as brokers¹⁷ between a franchisor and the potential franchisee have been accused of misrepresentation,¹⁸ with the commission nature of the brokerage being viewed as encouraging sales of franchises over advise to prospective purchasers.¹⁹ This is an area where franchisees and franchisors tend to agree that tighter laws could be enacted. As I understand it, regulatory initiatives have in the past few years been put into place in California and other states. These initiatives may well serve as a guidepost for a revision to the FTC Rule, a clarion call to federal regulators, or even action by Congress.²⁰

5. In the loan and guaranty context, there should be more upfront, bold warnings, such as concerning the SBA's Franchise Directory. There should be more information about the process for issuing, or not, a loan or a guaranty of the loan.

6. The parol evidence rule should not serve as a means to strike evidence outside the four-corners of a franchise contract that was allegedly procured through the franchisor's or its agent's misstatements.²¹

7. Franchisors should be restricted from making unilateral changes to the Operations Manual or other documents ancillary to the franchise contract insofar as those changes are instituted without good cause or, even if undertaken for sufficient reasons, would impose onerous (excessive) costs upon franchisees, such as for changes to work hours, a remodeling of the store location, or other

¹⁷ Bibby Group, *Is Your Guide a Franchise Broker or Franchise Consultant?* (June 1, 2021), <https://www.bibbygroup.com/franchise-brokers-vs-franchise-consultants/> ("The franchise broker (by any other name) represents franchisors, not buyers, and is paid a fee (or commission) if a franchise buyer chooses one of the franchises with whom they have contracted for their services."). Bibby goes on to contend that a franchise consultant, on the other hand, "charges buyers a fee to advise and protect them and their best interests. The most important aspect of this protection is serious franchise due diligence that breaks down and analyzes a franchise offering." *Id.* Bibby says, "You will not find a commissioned broker breaking down a franchise they represent and pointing out its flaws. They're paid to sell a concept, not critique it." *Id.*

¹⁸ See The Franchise Maker, *Franchise Legal Problems Due to Sales Misrepresentations*, <https://www.thefranchisemaker.com/learningcenter/franchise-legal-problems-due-to-sales-misrepresentations/> (last visited March 14, 2022) (contending that over 60% of all franchise litigation stems from franchise sales misrepresentation, and in effect placing much of the blame on franchise brokers who have duped both the franchisor and the franchisee).

¹⁹ As stated by the Bibby Group:

The broker will introduce prospects to franchises they might otherwise not see. But there are at least three negatives. One, there will be a barrage of introductions that can create more confusion than clarity. Two, the broker will only make introductions to franchises with whom they have a fee arrangement. And three, there will be no due diligence performed. Prospective buyers will be presented with *blue sky and happiness* as opposed to the investigative steps that should be part of buying a franchise.

Bibby Group, *supra* note 17.

²⁰ For a rosy view of the work of franchise brokers, see Franchise Brokers Ass'n, *Franchise Broker or Consultant?* (July 22, 2020), <https://www.franchiseba.com/franchise-consultant-vs-franchise-broker/#:~:text=Franchise%20brokers%20are%20hired%20by,their%20valued%20services%20for%20free.>

²¹ Robert W. Emerson, *Franchising and the Parol Evidence Rule*, 50 AMERICAN BUS. L.J. 659 (2013).

modifications to the franchise system “rules.” Many factors would need to be considered in terms of proportionality, time, revenues and expenses.²²

8. Non-disparagement clauses should be prohibited inasmuch as they (1) harm the exchange of information between current franchisees, (2) impede the efforts of prospective franchisees seeking to learn about the business from current franchise owners, and (3) violate the fundamental norms of open, robust speech, necessary for a free society, and is extremely useful for smart business planning and the effective execution of those plans.

9. All Franchise Disclosure Documents (FDDs) should be maintained on an easily accessible website, perhaps maintained by the FTC or through a government contractor.

There are other substantive areas of law that could be clarified, but – over time – common law jurisprudence may have the nuance and depth that legislation may not accomplish. In other words, a statute could set a basic standard, but – importantly – leave the courts and regulators to deal with specific fact patterns.

Here are three important examples:

Statutes on termination (good faith and fair dealing, good cause, etc.) likely could be drafted simply as an attempt to ensure due process for franchisees who have been terminated or who have voluntarily left a franchise network.²³

Statutes on ownership of goodwill could, again, be enacted to deal with a procedural issue – providing for a transfer of rights process for some recognition of the equity to which a franchisee is entitled. As with termination, the precise delineation of how to resolve the substance may be best left to commentators, courts, accountants, and others.²⁴

Statutes on non-competes could be crafted to include rules covering extreme examples of poaching and encroachment, but the delineation of principles for a court to follow with respect to the usual substantive law issues would likely either be too basic (just a repetition of standards found in the case law) or too involved to legislate without extensive groundwork undertaken beforehand.²⁵

²² See Robert W. Emerson, *Franchising Lessons in the Age of Incivility: Operations Manuals and Trade Secrets*, 29 *Texas Intell. Property L.J.* 305 (2021).

²³ A few of my articles touching upon these matters are: Robert W. Emerson, *The Faithless Franchisor: Rethinking Good Faith in Franchising*, 24 *U. PENN. J. BUS. L.* ____ (issue 2, 2022); Robert W. Emerson & Steven A. Hollis *Bound by Bias? Franchisees' Cognitive Biases*, 13 *OHIO STATE BUS. L.J.* 1 (2019); Robert W. Emerson, *Franchise Terminations: 'Good Cause Decoded'*, 51 *WAKE FOREST LAW REVIEW* 103 (2016); Robert W. Emerson, *Franchising Constructive Termination: Quirk, Quagmire or a French Solution?* 18 *U. Penn. J. Business L.* 163 (2015).

²⁴ A sampling of articles on goodwill and related topics include: Robert W. Emerson & Charlie C. Carrington, *Devising a Royalty Structure that Fairly Compensates a Franchisee for its Contribution to Franchise Goodwill*, 14 *VIRGINIA LAW & BUS. REV.* 279 (2020); Robert W. Emerson, *Thanks for the Memories: Compensating Franchisee Goodwill after Franchise Termination*, 20 *U. PENN. J. BUS. L.* 286 (2017); Robert W. Emerson, *Franchise Savoir-Faire*, 90 *TULANE L. REV.* 589 (2016); Robert W. Emerson, *Franchise Goodwill: "Take a Sad Song and Make It Better"*, 46 *U. MICH. J. LAW REFORM* 349 (2013); W. Michael Garner & Elliot R. Ginsburg, *Nailing the Blob of Mercury: Goodwill in Franchising*, 33 *FRANCHISE L.J.* 149 (2013).

²⁵ See generally *COVENANTS AGAINST COMPETITION IN FRANCHISE AGREEMENTS* (eds. Michael R. Gray & Natalma M. McKnew, 3d ed., ABA Forum on Franchising 2012); Robert W. Emerson, *Franchising Covenants Against Competition*, 80 *IOWA LAW REV.* 1049 (1995).

The Two SBA Bills

The “Small Business Administration Franchise Loan Transparency Act of 2021” (S. 1120) provides in part:

Sec. 4 REQUIRED DISCLOSURES.

(a) IN GENERAL.—Subject to subsection (b), a franchisor, except for a franchisor of a franchise in the lodging industry, that qualifies for guaranteed lending from the Small Business Administration for the franchises of the franchisor shall, at a minimum, disclose in the disclosure document required to be furnished by the franchisor to any prospective franchisee the following information for each of the 3 years preceding the date of the disclosure document: (1) The average and median first-year revenues for all businesses operated under franchises granted by the franchisor, in accordance with the Financial Performance Representation Commentary. (2) The total number of businesses operated under franchises granted by the franchisor that, during the first year of operation, either— (A) ceased operations; or (B) were transferred to a new franchisee. (3) The average and median revenues for all businesses operated under franchises granted by the franchisor, in accordance with the Financial Performance Representation Commentary.

(b) LIMITATION.—A franchisor may not disclose to a prospective or current franchisee, directly or through a third party, any information relating to revenue that conflicts with the information relating to revenue provided under subsection (a) in a disclosure document unless the relevant franchise purchase includes 1 or more businesses under the relevant franchise that are in existence on the date on which the disclosure is made, in which case the franchisor shall disclose to the prospective or current franchisee the relevant information relating to revenue as of the date on which the disclosure is made with respect to those businesses.

SEC. 5. ENFORCEMENT.

The Administrator of the Small Business Administration— (1) shall enforce the requirements under this Act; and (2) may hold a franchisor liable for the balance of any loan obtained through a violation of this Act.

I very much understand the concern motivating this bill. There are indeed outrageous examples of franchisees misled, defrauded, or otherwise caused great suffering and financial harm due to, at the very least, franchisor incompetence (and often malfeasance). However, at this point in time, I am reluctant to support a mandated Financial Performance Representation (“FPR”) for, *inter alia*, these reasons:

1. The FPR, if it is to be mandated, should come from the Federal Trade Commission (“FTC”), not the Small Business Administration. The FTC is the agency with the experience, and

the ties to the franchise law community, to make it the logical administrative “location” for a FPR. While certainly the agencies could coordinate with respect to enforcement and regulations, if the SBA put forth a FPR, I do wonder whether housing a mandated FPR, with penalties, in the SBA opens it up to more challenges on procedural and administrative grounds that would be avoided if emanating from the FTC. But this is not the main reason for my reluctance to endorse S. 1120.

2. The problems that drive the outrage over the suffering of franchisees who bought into a bad system may not have been avoided by a mandated FPR. Incompetent or malfeasant franchisors may not provide the required information, at least in the comprehensive, timely, accurate manner in which it should have been provided. Again, though, this is not what principally motivates my reluctance to endorse S. 1120 (and I am not happy with any argument that, in effect, says a rule should not be passed if the main objection is simply that bad actors likely will not follow the rule).

3. My main objection to S. 1120 is that there is evidence that the non-mandatory nature of the FPR may actually work better as a signaling device to prospective franchisees. As time goes by, the FPR is increasingly being provided – with recent figures indicating that about two-thirds of all Franchise Disclosure Documents (FDDs) now provide an Item 19 FPR (up from about 20% of FDDs when the modified FTC Rule first went into force about a dozen years ago. There is much in the academic literature, by business professors, noting these possible signaling effects.

4. Many of the problems associated with profit representations are the statements apart from an FDD, and often occur regardless of whether an FPR is included in the FDD.

The franchise representative or a sales representative ‘may tell a prospective franchise directly and through subtle means that the FDD has been reviewed and approved by the government and it’s a safe investment.’ FTC’s regulation of FDDs contribute to this problem. For example, the FTC allows – but does not require – franchisors to include financial information in Item 19 of the FDD. Franchisors are also permitted to include in Item 19 a disclaimer to the effect that any other financial information provided outside Item 19 is illegal and should not be relied upon as factual.⁴⁸ In practice, this is a problematic provision; it allows franchisors to connect investors with buyer development agents or brokers, franchise owners, newsletters, or other projections or data without the requirement of accuracy as franchise investors do not understand that financial material provided outside the FDD may not be reliable.²⁶

I very much recognize that this is an extremely serious problem, but I think there are, at least initially, better ways to confront the problem, such as improved administrative enforcement, removal of parol evidence rule or other evidentiary barriers to proof of cases for misrepresentation, and heightened oversight of brokers or other third parties who may engage in bad acts.

²⁶ STRATEGIES TO IMPROVE THE FRANCHISE MODEL, *supra* note 15, at 10 (citations omitted).

5. I do think there may be ways, with respect to the numbers and reporting requirements, to improve Item 20 disclosures about outlet numbers and thereby meet some of the concerns about Item 19 FPRs.

6. If any statements are being made by franchisors or their representatives to lenders or to the SBA in connection to a franchisee's obtaining a loan or loan guaranty, it is difficult for me to comprehend why such statements should be shielded from the franchisee, who will be on the hook for the loan.²⁷ I certainly understand and respect the need for confidentiality, but if banks and the SBA need documents to evaluate a franchise system into which a franchisee will become a dependent party, with its money on the line, I think there should be a very high barrier to overcome in terms of shielding those franchise network related documents from someone whose risks are so much tied to that very network. This, however, is not an area in which I have undertaken research.

As for "SBA Franchise Loan Default Disclosure Act," (S. 2162), I favor that bill. As I understand it, this is not – or at least it should not be – a controversial Act for franchisors, franchisees, or those who represent them. It is an attempt to provide more information – important information – and (just as important) an attempt to afford to prospective franchisees greater accessibility to this information. That is a good thing. Whether people read the disclosures, and what they do with the information, is now often the real issue.

²⁷ *Id.* at 55 n.228 ("In 2014, SBA's Chief Franchise Counsel, Stephen Olear, recommended that franchisors consider providing a projection directly to the lender by passing the franchise investor (the ultimate borrower). "... Most importantly in the financing context, the requirements in Item 19 for the preparation of financial performance representations do not apply to information provided directly by the franchisor to lenders of prospective franchisees. Franchisors who do not provide financial performance representations to prospective franchisees but want to provide information to prospective lenders, or who wish to provide additional information to these lenders, are free to do so. This provides franchisors the opportunity to give valuable information to facilitate the financing of its franchisees without being bound by the requirements of Item 19. However, this can introduce a new set of risks the franchisor must be prepared to manage...First, any information provided to lenders should only be provide after obtaining a confidentiality and non-disclosure agreement from the lender...").

Chairman CARDIN. Professor, thank you for your testimony. We appreciate it very much.

Dr. Yelowitz.

STATEMENT OF AARON YELOWITZ, Ph.D., PROFESSOR OF ECONOMICS, UNIVERSITY OF KENTUCKY, SENIOR FELLOW, CATO INSTITUTE, LEXINGTON, KY

Dr. YELOWITZ. Chairman Cardin, Ranking Member Paul, and members of the Committee, thank you for the honor of participating in today's hearing. My name is Aaron Yelowitz, and I serve as a Professor of Economics at University of Kentucky and a Senior Fellow at Cato Institute.

The franchising model, which allows aspiring entrepreneurs to adopt a proven business model while avoiding many of the mistakes associated with a new business, impacts 730,000 establishments and 8.4 million workers in the United States. Although many people associate franchising with fast food, there are thousands of brands across 300 business lines.

From entry into markets to jobs and wages to the use of SBA loans, emerging evidence shows that the conditions franchisees operate under are not substantively different than small, independent business owners. Singling out franchising for additional regulation will make the franchising model less viable, in turn, leading to less competition and higher consumer prices at a time when inflation is already at 40-year highs. The degree to which the Federal Government should be involved in regulating private businesses and subsidizing business loans is a legitimate question, especially with high taxpayer costs per jobs created, but singling out franchises is unwarranted.

Proposals to further regulate franchise disclosure that are solely confined to the SBA are misplaced. Franchise sales and disclosure is heavily regulated by the FTC, which administers the FTC Franchise Rule requiring disclosure in 23 areas.

Given the paucity of data on franchising, Oxford Economics surveyed more than 4,000 franchisees and published a comprehensive study in 2021. Oxford found franchising offers a path to entrepreneurship but is especially valuable for new entrepreneurs, veterans, minorities, and women.

Some popular books describe franchising as running a business with training wheels. Franchisors provide training wheels to keep new franchisees balanced until they can pedal on their own. This view is confirmed in the study. Thirty-two percent of respondents report they would not own a business without the franchising model. Without this model, 223,000 establishments employing some 1.8 million workers would not exist. Franchisees value the franchisors' support in areas where an entrepreneur running a small, independent business would likely make mistakes. Intuitively, many business owners would not have gone down that uncertain path without such support.

Critics of franchising often focus on the wages and labor violations. Oxford compared wage levels and growth for new hires at franchises and independent businesses. Wages and wage growth were virtually the same for new hires with no more than a 13-cent difference in any of the first 20 months of employment.

SBA loans account for about 1 percent of all small business loans. A recent study links SBA loans to businesses. The loans did encourage job growth. However, the taxpayer costs from charge-offs in administration range from \$21,580 to \$25,450 per job created while the jobs themselves paid about \$30,000 per year on average.

Business lending is important to franchisees. The Oxford study finds that 21 percent of respondents report being capital constrained when starting their first franchise business.

Critics have expressed concern about default rates. I have analyzed SBA loans from fiscal year 2010 onward based on franchise status, essentially a comparison of franchisees and independent businesses. Among 7(a) and 504 loans, about 10 percent went to franchisees. As time lapses from when a loan originates, charge-off rates increase although the charge-off rate for 2020 through 2022 may be misleading because of debt relief forbearance from the CARES Act.

In my view, there are very modest differences in charge-offs. In most years, the difference in charge-offs between franchisees and independent businesses is statistically insignificant. For example, in fiscal year 2010, 7.8 percent of franchisees' SBA 7(a) loans were charged-off, slightly lower than the 8 percent for independent businesses. For the 504 loan program, charge-offs were nearly the same after 2011. The SBA data does not support the characterization of franchise loan charge-offs as anything out of the ordinary. Rather than being squeezed by corporate franchisors to commit wage violations or default on loans, the data paints a picture of franchisees performing much like small, independent businesses.

Small businesses promote competition. Some recent proposals would impose new burdens on the franchisor-franchisee relationship, which is private and voluntary. The proposed PRO Act will codify an expanded joint employer standard. The so called "ABC test" in the PRO Act could potentially classify franchisees as employees of their brand instead of small businesses, which in reality they are. Both provisions would ultimately lead to fewer franchise establishments in the marketplace. Such proposals that interfere with the existing franchisor-franchisee relationship run the risk of raising consumer prices even further.

Thank you.

[The prepared statement of Dr. Yelowitz follows.]

Testimony of:
Aaron Yelowitz
Professor of Economics, University of Kentucky
Senior Fellow, Cato Institute

Hearing for:
Small Business Franchising:
An Overview of the Industry, SBA's Role, and Legislative Proposals
U.S. Senate Committee on Small Business & Entrepreneurship
March 16, 2022

Chairman Cardin, Ranking Member Paul, and Members of the Committee, thank you for the honor of participating in today's hearing. My name is Aaron Yelowitz, and I serve as a Professor of Economics at University of Kentucky and a Senior Fellow at Cato Institute. My views expressed here today are informed by my research and reading of the literature on franchising and the role of the SBA in lending.

The franchising model – which allows aspiring entrepreneurs to adopt a business format that has proven to work while avoiding many of the growing pains and mistakes associated with a new business – impacts approximately 730,000 establishments and 8.4 million workers in the United States. Although many people associate franchising with the fast-food industry, there are thousands of franchise brands in approximately 300 business lines, including automotive, business-to-business services, cell phone repair, fitness, hair care, home repair services, tutoring, spas, childcare, pet care, and senior care.¹ Quick-service restaurants make up 25% of franchised establishments in the U.S., meaning the reach of the franchising model goes far beyond fast food.²

In a variety of contexts – from entry into markets, to jobs and wages, to the use of SBA business loan guarantee programs – emerging evidence shows that **the conditions that franchisees operate under are not substantively different than owners of other small independent businesses**. I'll review pertinent numbers today from some compelling studies, which leads me to conclude that the motivation to single out the franchise model for additional regulation is unnecessary. Such regulation would likely increase costs and make the franchising model less viable, in turn leading to less entry, more exits, and ultimately less competition. Reduced market competition will increase consumer prices at a time when inflation is already at 40-year highs, thereby harming the American public.

The degree to which the federal government should be involved in regulating private businesses and subsidizing business loans is a legitimate question but singling out the franchisor-franchisee relationship is unwarranted. Furthermore, proposals to further regulate franchise disclosure that are solely confined to the SBA are misplaced from a policy perspective.³ Franchise sales and disclosure is heavily regulated

¹ <https://www.census.gov/library/stories/2018/03/franchises.html> and https://openforopportunity.com/wp-content/uploads/2021/09/IFA_The-Value-of-Franchising_Sep2021.pdf

² https://openforopportunity.com/wp-content/uploads/2021/09/IFA_The-Value-of-Franchising_Sep2021.pdf

³ See, for example, S.1120, the Small Business Administration Franchise Loan Transparency Act – a bill that would require franchisors to disclose in Item 19 of Franchise disclosure documents required to be furnished by the franchisor to any prospective franchisee average and median first-year revenues for all businesses operated under franchises for the preceding three years, and would hold a franchisor liable for the balance of any SBA backed

by the Federal Trade Commission, which administers the FTC Franchise Rule, and requires franchise brands to offer disclosure in 23 areas.

Franchising and Economic Opportunity

Given the paucity of data to study the franchisor-franchisee relationship, Oxford Economics published a comprehensive study in September 2021 that offers many insights on the issues we are discussing today. The Oxford research team surveyed more than 4,000 individual franchisees across a vast array of industries, and asked about compensation, franchisor support, and involvement in the local community.

The first key takeaway is that franchising offers a path to entrepreneurship but is especially valuable for new entrepreneurs, veterans, minorities, and women. Some popular books describe the franchising model as “running a business with training wheels” – franchisors provide a set of training wheels to keep new franchisees balanced until they can pedal on their own.⁴ This viewpoint is robustly confirmed in the Oxford study. **Overall, 32% of respondents report they would not own a business if they were not franchisees. The Oxford team calculates that without franchisor support, approximately 223,000 establishments employing some 1.8 million workers wouldn’t exist if franchising was not an option.** The survey found that franchisees valued the franchisor’s support in the areas of training, meetings and events, and technology platforms. These are areas where a new entrepreneur running a small independent business would likely encounter growing pains and make mistakes.⁵ Intuitively, these responses are consistent with the idea that franchising provides a path to entrepreneurship, and many owners wouldn’t have gone down that uncertain path without such support.⁶

Franchising, Jobs, and Wages

Critics of franchising such as Professor David Weil often focus on the wage structure and labor violations.⁷ Weil’s central thesis is that in contrast to an idealized past in which large, vertically integrated employers dominated the American economy, today’s labor markets are characterized by a “fissured workplace,” in which employers have shed all non-core employees in order to reduce wages. Weil presents anecdotes of a handful of horror stories, but he doesn’t produce any evidence that franchise businesses pay less. In fact, there is evidence to the contrary.

One of the mechanisms in the fissuring thesis is that franchisees have incentives to take short-cuts – including low wages – because they can free-ride off the brand’s reputation. The Oxford analysis of wages and wage growth compares franchised businesses to individually owned-and-operated businesses in 2018 and 2019, prior to the pandemic. The analysis used arm’s-length data from the

loans obtained while violating these requirements and S.2162, the SBA Franchise Loan Default Disclosure Act – a bill to require the SBA to publish loan default rates by franchise brands during the preceding 10-year period.

⁴ Michael Seid and Dave Thomas, “Franchising for Dummies, 2nd Edition,” 2006.

⁵ Lafontaine et al. (2019) examine survival and growth prospects of franchised and independent businesses. They find that franchised businesses on average exhibit slightly higher survival rates than independent businesses, although the effect appears to be short lived (one to two years). This is however still very relevant, considering that one third of new businesses are estimated to fail within their first two years. In addition, the authors find that franchised businesses grow faster than independent businesses in the first two years, but no difference is detected beyond that point. See Lafontaine, Francine, Marek Zapletal, and Xu Zhang. “Brighter prospects? Assessing the franchise advantage using census data.” *Journal of economics & management strategy* 28.2 (2019): 175-197.

⁶ https://openforopportunity.com/wp-content/uploads/2021/09/IFA_The-Value-of-Franchising_Sep2021.pdf, p. 5.

⁷ Weil, David. *The Fissured Workplace*. Harvard University Press, 2014.

payroll company Homebase. Small, independent business owners have strong incentives to maintain their reputation, especially where social media postings claiming worker mistreatment can lead to viral stories, the loss of customers, and, paradoxically, make it even harder to recruit and retain staff. **Yet wages and wage growth were virtually the same for newly hired workers in franchised businesses and independent ones. Wages grew from approximately \$10.30 per hour at the start of employment to around \$11.10 per hour after 20 months, with no more than a 13 cent difference in any month.** Moreover, newly hired workers in franchised businesses were more likely to be promoted to manager.

Finally, the Oxford survey of 4,000 franchisees found that the share of workers offered various benefits at small franchise firms was on par with the share at small non-franchise establishments. This data-driven descriptive evidence presents no support for the fissuring hypothesis.

Franchising and SBA Lending

SBA loans are a tiny share of the total banking business, accounting for about 1% of all small business loans.⁸ A recent peer-reviewed *Journal of Finance* study links SBA loans to the Census Bureau's Longitudinal Database, to compare similar businesses that either received or did not receive an SBA loan guarantee. SBA loans did encourage job growth of 3.0 to 3.5 jobs per million dollars of loan, suggesting real effects of credit constraints. Over the 1992 to 2007 period, the study estimated total job creation in the range of 690,000 to 813,000 from SBA loans in the 7(a) and 504 loan programs. However, this is about 5 to 10 times smaller than the 5.6 million job figure that applicants predicted as part of "jobs supported." The taxpayer cost – from loan default charge-offs and other administrative costs – ranged from \$21,580 to \$25,450 per job created. To put this in perspective, the study estimates that the jobs created by the SBA program pay an average of \$30,000 per year.

Business lending is important to franchisees; the Oxford survey finds that 21% of respondents report being capital constrained when starting their first franchise business and that being a franchisee provided them with access to capital. Nonetheless, there are concerns about default rates among franchisees.⁹

I've recently analyzed SBA loans from publicly available data on the SBA webpage; I will caution that this analysis is preliminary.¹⁰ The tables show loan performance from Fiscal Year 2010 onward based on franchise status – essentially a comparison of franchisees and independent businesses.¹¹ For technical

⁸ Brown, J. David, and John S. Earle. "Finance and Growth at the Firm Level: Evidence from SBA Loans." *The Journal of Finance* 72.3 (2017), 1039-1080.

⁹ A 2013 report by the United States General Accountability Office notes very high loan defaults in the SBA 7(a) program among select franchisees from 2003 to 2012. The findings were recently cited in a report critical of franchising lending. See United States Government Accountability Office. *Small Business Administration Review of 7(a) Guaranteed Loans to Select Franchises*. GAO-13-759 (Washington, DC: Government Accountability Office, 2013). Accessed from: <https://www.gao.gov/assets/gao-13-759.pdf>. See also: From the Office of Senator Cortez Masto, "Strategies to Improve the Franchise Model: Preventing Unfair and Deceptive Franchise Practices." April 2021. Accessed from: <https://www.cortezmasto.senate.gov/imo/media/doc/Franchise%20Report%20from%20the%20Office%20of%20Senator%20Cortez%20Masto.pdf>.

¹⁰ See <https://data.sba.gov/dataset/7-a-504-foia>, accessed 3/11/2022.

¹¹ This uses files "FOIA - 504 (FY2010-Present) asof 211231.csv", "FOIA - 7(a)(FY2010-FY2019) asof 211231.csv", and "FOIA - 7(a)(FY2020-Present) asof 211231.csv". Loan performance was evaluated as of December 31, 2021 in

reasons dealing with how lenders input franchise status during the loan process, any difference in charge-offs for franchisees is likely overstated for loans prior to 2018, yet even with these technicalities there is virtually no difference in charge-offs.¹² For SBA 7(a) loans, there are nearly 650,000 loans, of which 9.7% were to franchisees. For SBA 504 loans, there are nearly 90,000 loans, of which 10.1% were to franchisees. As more time lapses, there is greater possibility of charge-offs, although the charge-off rate for 2020 through 2022 may be misleading because there has been debt relief forbearance for existing and new 7(a) and 504 loans from the CARES Act.

In my view, the tables show very modest differences in charge-offs in the SBA data. Between fiscal years 2010-2014 as well as 2018 onward, the difference in charge-offs between franchisees and independent businesses is statistically insignificant for the 7(a) loan program. For example, in FY 2010, 7.8% of franchisees' SBA loans were charged off, slightly lower than the 8.0% for independent businesses. Between the years 2015 and 2017, the difference is significant with an estimate of around 1.0 percentage point (pp). The same patterns emerge in the 504 loan program, where charge-offs were nearly the same for all years after 2011. In contrast, the jobs supported by franchisees – for both the 7(a) and 504 programs – are markedly higher for franchisees than independent businesses.

In conclusion, there is no clear motivation to single out the franchisor-franchisee relationship. Much like the out-of-context characterization of franchisee wages and wage violations in Weil's book, **the SBA data do not support the characterization of franchisee loan charge-offs in Senator Cortez Masto's report as anything out of the ordinary.**¹³ Rather than being squeezed by corporate franchisors to commit wage violations and default on loans, the data paints a picture of franchisees performing much like small independent businesses.

Franchising Legislative Proposals, Competition, and Consumer Prices

Small businesses such as those created by franchising promote competition and increase the variety of goods and services for consumers. Some recent legislative proposals would impose new regulatory burdens on the franchisor-franchisee relationship, which is a private, voluntary, and mutually beneficial agreement. For example, the proposed "Protecting the Right to Organize" Act, or the PRO Act, would codify into law an expanded "joint employer" standard, whereby franchisors can be held responsible for actions taken by their franchisees.¹⁴ The so-called "ABC test" – also included in the proposed PRO Act –

the files and arranged by loans originating each fiscal year, which runs from October to the next September for any year.

¹² Personal correspondence with Darrell Johnson, franchise economist and CEO of FRANdata. The accurate identification of franchise loans historically was corrected only for loans in default. Prior to 2018, SBA did not require lenders to identify franchise loans separately (technically it was on the input form but it required supporting work and many lenders skipped doing it because there was no impact on the guarantee) so lenders often didn't report franchise loans they put on the books. That led to underreporting of franchise activity until loans defaulted, making the percentage of franchise loans that defaulted overstated, often significantly. With the changes in SBA rules regarding franchises instituted in 2017, that should no longer be the case but any loan comparisons prior to 2018 are suspect.

¹³ My tabulations of the SBA data, in fact, virtually replicate some of the findings in the Cortez Masto report (p. 12). The report finds 51,907 business 7(a) loans, of which 6,874 loans went to franchise businesses in 2019. My tabulations showed 51,907 and 6,882 (differs by 8 loans) for FY 2019, respectively. The Cortez Masto report shows 6,099 business 504 loans, of which 621 went to franchise businesses in 2019. My tabulations show 6,099 and 623 (differs by 2 loans) for FY 2019 respectively.

¹⁴ <https://www.congress.gov/bill/117th-congress/house-bill/842> .

could potentially classify franchisees as employees of their brand, instead of small businesses, which in reality they are. This would essentially eliminate the entire concept of franchising as a business model. **Both provisions would discourage entry, encourage exits, and ultimately lead to fewer franchised establishments in the marketplace. In turn, this would lead to reduced competition and higher consumer prices.**

About the Witness

Yelowitz is a professor in the Department of Economics at the University of Kentucky. He is also a joint faculty member in the Martin School of Public Policy and Administration at the University of Kentucky, a senior fellow with the Cato Institute, and a research fellow with the Institute of Labor Economics (IZA). Yelowitz has received compensation as a consultant to the International Franchise Association. All opinions expressed here are those of the author, and not necessarily those of any coauthors, funders, or institutions.

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FY	Charge-offs			Jobs Supported by Loan		
	Franchisees	Independent	Difference	Franchisees	Independent	Difference
2010	7.8%	8.0%	-0.2 pp	18.6	11.3	7.2 jobs ***
2011	6.2%	5.8%	0.4 pp	21.0	12.2	8.8 jobs ***
2012	5.2%	5.4%	-0.2 pp	20.7	11.7	9.0 jobs ***
2013	5.0%	4.8%	0.2 pp	19.4	10.6	8.8 jobs ***
2014	5.4%	5.0%	0.4 pp	17.9	9.7	8.2 jobs ***
2015	5.9%	4.8%	1.2 pp ***	18.3	9.8	8.5 jobs ***
2016	5.4%	4.3%	1.1 pp ***	17.8	9.0	8.8 jobs ***
2017	4.9%	3.6%	1.3 pp ***	17.3	9.0	8.3 jobs ***
2018	2.7%	2.6%	0.1 pp	16.6	8.7	7.9 jobs ***
2019	1.3%	1.1%	0.2 pp *	16.5	9.1	7.4 jobs ***
2020	0.2%	0.2%	0.1 pp	15.6	10.0	5.7 jobs ***
2021	0.0%	0.0%	0.0 pp	16.8	11.2	5.7 jobs ***
2022	0.0%	0.0%	0.0 pp	17.4	9.5	7.9 jobs ***

Notes: Yelowitz's tabulation of SBA 7(a) loan data. N=648,809. 9.7% of loans are to franchisees.

Definitions:
Charge-offs – "Current status of loan is charged off. Other options are undisbursed, paid in full, cancelled, and exempt."
Jobs supported – "Total Jobs Created + Jobs Retained as reported by lender on SBA Loan Application. SBA does not review, audit, or validate these numbers - they are simply self-reported, good faith estimates by the lender."

Source: <https://data.sba.gov/dataset/7-a-504-foia>
 *** p>0.01, ** p>0.05, * p>0.01

FY	Charge-offs			Jobs Supported		
	Franchisees	Independent	Difference	Franchisees	Independent	Difference
2010	4.1%	2.3%	1.8 pp ***	15.5	10.7	4.8 jobs ***
2011	3.3%	1.3%	2.1 pp ***	15.4	10.9	4.4 jobs ***
2012	1.4%	1.4%	-0.1 pp	16.5	13.1	3.4 jobs ***
2013	0.6%	1.0%	-0.3 pp	16.5	11.5	5.1 jobs ***
2014	1.0%	0.8%	0.2 pp	17.2	10.9	6.4 jobs ***
2015	0.6%	0.6%	-0.1 pp	15.1	10.4	4.7 jobs ***
2016	0.6%	0.5%	0.1 pp	15.6	10.1	5.6 jobs ***
2017	0.2%	0.3%	-0.1 pp	12.6	9.4	3.2 jobs ***
2018	0.0%	0.1%	-0.1 pp	13.6	9.2	4.4 jobs ***
2019	0.0%	0.1%	-0.1 pp	13.1	8.3	4.8 jobs ***
2020	0.0%	0.0%	0.0 pp	11.8	7.7	4.1 jobs ***
2021	0.0%	0.0%	0.0 pp	12.3	8.4	3.9 jobs ***
2022	0.0%	0.0%	0.0 pp	14.7	9.9	4.8 jobs ***

Notes: Yelowitz's tabulation of SBA 504 loan data. N=88,524. 10.1% of loans are to franchisees.

Definitions:
Charge-offs – "Current status of loan is charged off. Other options are undisbursed, paid in full, cancelled, and exempt."
Jobs supported – "Total Jobs Created + Jobs Retained as reported by lender on SBA Loan Application. SBA does not review, audit, or validate these numbers - they are simply self-reported, good faith estimates by the lender."

Source: <https://data.sba.gov/dataset/7-a-504-foia>

*** p>0.01, ** p>0.05, * p>0.01

Chairman CARDIN. Thank you very much for your testimony.
Leanne Stapf.

**STATEMENT OF LEANNE STAPF, CHIEF OPERATING OFFICER,
THE CLEANING AUTHORITY, COLUMBIA, MD**

Ms. STAPF. Chairman Cardin, Ranking Member Paul, and distinguished members of the Committee, my name is Leanne Stapf, and I serve as Chief Operating Officer and franchise owner of The Cleaning Authority, and I live in Columbia, Maryland. Thank you so much for this invitation. I am really jazzed to be here.

I am both a franchisor and a franchisee, and I appear before you today on behalf of the International Franchise Association. In our view, at this stage of the economic recovery, the state of franchising has never been stronger. While our businesses need more workers, today franchisee satisfaction has never been higher. According to Franchise Business Review, 88 percent of franchise owners say they enjoy operating their business. Franchises have led the economic recovery with the highest growth rate since we have been tracking the data, reaching nearly 775,000 total franchise establishments in 2021 and achieving an astounding 16.3 percent growth in output.

Mr. Chairman, franchising remains the ultimate hybrid business model between standalone small businesses and big corporations, and this model continues to empower people from all backgrounds to achieve their dream of business ownership more than any other format in America. I have seen firsthand how franchising can change lives and change communities. Franchising democratizes business ownership for people of all backgrounds. To be clear, I would not own a business if it were not for franchising, and according to recent research by Oxford Economics, 32 percent of all franchise owners report they would not own a business if they were not a franchisee. This proportion is even greater among both female owners and owners for whom a franchise was their first business. Franchising also boasts a higher ownership rate by people of color than among non-franchise businesses.

There are just so many of us that have that entrepreneurial spirit but do not necessarily have the expertise to really be efficient at all aspects of running the business, and the franchise offers us that. That structure, that framework, that is going to save us massive amounts of time, money, and frustration.

I came into franchising after starting my career in computer programming. I was looking for the next step in my career and ready for a lifestyle change that allowed me to be with my family more, and I found a job description matching my technical expertise that came up for The Cleaning Authority, and soon after I was hooked.

I am so proud of what The Cleaning Authority has accomplished for more than 200 communities we operate in. Through our TCA Cares—this was a program designed by franchise owners and facilitated by the franchisor—we have had 12 food drives, collecting over 1 million pounds of food equal to 894,000 meals to over 600 food banks within our communities. Last year, our first coat and outerwear drive, we saw almost 10,000 articles of clothing donated. We also award ten \$1,000 scholarships each year to employees and

their dependents of The Cleaning Authority to align with our mission to positively impact the quality of life of the people we employ.

But our story is not unique. The Oxford Economics research referenced in the testimony showed that some 65 percent of franchise owners gave to local charities and they donated a total of \$1.5 billion to charities last year. In addition, franchise owners purchase significant percentage of their inputs from local suppliers, thus contributing to their local economies through their supply chains. Without franchise small businesses, if franchises were replaced by big corporations on Main Street, all of this community investment goes away.

Chairman Cardin, thank you so much for holding today's hearing. I want to close by noting that IFA is very supportive of SBA loan programs. These loan programs are essential to giving opportunity to those who may not have access to capital. IFA is also very supportive of the FTC Franchise Rule, which provides the guidelines for the disclosure of the majority of data franchise brands provide to empower franchise owners.

And finally, you might have heard an old saying: If you want to go fast, go alone. If you want to go far, go together.

So I believe America needs to go far, and I believe we need to go together. And I believe we can do it by keeping franchising alive and well.

We hope Senators will continue to support the franchise businesses in the State, and I would be happy to answer any questions you may have. Thank you.

[The prepared statement of Ms. Stapf follows:]



LEANNE STAFF

CHIEF OPERATING OFFICER AND MULTI-UNIT FRANCHISE
OWNER OF THE CLEANING AUTHORITY
COLUMBIA, MARYLAND

TESTIMONY BEFORE THE U.S. SENATE COMMITTEE ON SMALL
BUSINESS AND ENTREPRENEURSHIP

HEARING ON “SMALL BUSINESS FRANCHISING: AN OVERVIEW OF
THE INDUSTRY, SBA’S ROLE, AND LEGISLATIVE PROPOSALS”

MARCH 16, 2022

Introduction

Chairman Cardin, Ranking Member Paul, and distinguished members of the Senate Committee on Small Business and Entrepreneurship. My name is Leanne Stapf, and I serve as Chief Operating Officer and multi-unit franchise owner of The Cleaning Authority, which is part of Maryland-based Authority Brands. I look forward to sharing my experience with you today.

Thank you for the invitation to appear before this Committee to discuss small business ownership and the views of local business owners as it relates to empowering American workers in today's hearing. I appear before you on behalf of the International Franchise Association, the world's oldest and largest organization representing franchising worldwide. The IFA works protect, enhance and promote franchising and the approximately 775,000 franchise establishments that support nearly 8.2 million direct jobs, \$787.7 billion of economic output for the U.S. economy, and almost 3 percent of the Gross Domestic Product (GDP). IFA members include franchise companies in over 300 different business format categories, individual franchisees, and companies that support the industry in marketing, law, technology, and business development.

I have been dedicated to franchising for the past 10 years as both a franchisor and franchisee and have seen firsthand how it can change lives and change communities. The economic benefits of the franchise model are undeniable, and the state of franchising has never been stronger. While our businesses need more workers, today 88% of franchisees are satisfied in their brands, and franchises have led the economic recovery, with the highest growth rate since we have been tracking data, reaching nearly 775,000 total franchise establishments in 2021 and achieving an astounding 16.3% growth in output. Franchising remains the ultimate, hybrid business model between standalone small businesses and big corporations, and this model continues to empower people from all backgrounds to achieve their dream of business ownership more than any other format in America. I hope today to bring to life the compelling evidence and research that clearly outline the economic benefits of the franchise business model.

Franchising has helped lead the economic recovery. By providing advancement opportunities at all levels of the economic ladder, from entry-level to manager and from manager to owner, franchises across America aided not only large-scale reentry into the workforce, but also the possibility of coming back better than ever. The unique business model also put the overall economy on more solid ground, with steady growth on business openings and output contributions.

There are so many of us that have an entrepreneurial spirit but don't necessarily have the expertise to be efficient at all aspects of running a business. A franchise offers that structure, that framework. Without that, there would be challenges – challenges that would cost time and money (and frustration). Most of these are avoidable if you have a solid franchise system at your back.

I am a franchise owner. I am a franchise founder. I am also the Chief Operating Officer for a franchisor. My story is just one of millions of folks who work in a franchised business or who are franchise owners, and I am here to tell you the truth about franchising.

In my testimony, I will describe how franchising positively effects the economy, how franchisees are generally satisfied with the current structure and stress the importance of addressing the relatively small number of fraudulent actors within the franchise industry.

The franchise business model

Franchising is perhaps the most important business growth strategy in American history. Today, there are approximately 775,000 franchise establishments, which support nearly 8.2 million jobs and \$7.87 billion of economic output for the U.S. economy.¹ “Franchising is a method of marketing goods and services” that depends upon the existence of the franchisor’s control over a trademark, other intellectual property or some other commercially desirable interest sufficient to induce franchisees to participate in the franchisor’s system by distributing goods or services under the franchisor’s name.²

Simply put: A franchisor is an entity that, in exchange for critical business support, collects royalties from its franchise owners who operate independently and locally owned and operated businesses. But like with any business, it all comes down to execution.

Despite how it is often characterized, franchising is not an industry. Franchising is a business growth model used within nearly every industry. More than 230 different sectors are represented in franchising, and franchise brand companies offer a huge range of services from lodging to fitness, home services to health care, plumbing, pest control, security, and lawn care. In my case, we specialize in home cleaning. Furthermore, notwithstanding any popular misapprehensions, franchising consists of far more than merely the “fast food” industry. There are far more local (50% of all franchised brands) and regional brands (34% of all franchised brands) whose names you might not recognize than the fast-food giants that garner the most attention. In fact, 63% of companies that franchise are not in the food services at all, and 83% are not in fast food.³

There are two principal explanations given for the popularity of franchising as a method of distribution. One is that it “was developed in response to the massive amounts of capital required to establish and operate a national or international network of uniform product or service vendors, as demanded by an increasingly mobile consuming public.”⁴ The other is that “franchising is usually undertaken in situations where the franchisee is physically removed from the franchisor, and thus where monitoring of the performance and behavior of the franchisee would be difficult.”⁵ These two motivations are consistent with a business model in which the licensing and protection of the trademark rests with the franchisor and the capital investment and direct management of day-to-day operations of the retail outlets are the responsibility of the franchisee, which owns, and receives the net profits from, its individually-owned franchise unit.

It is typical in franchising that a franchisor will license, among other things, the use of its name, its products or services, and its reputation to its franchisees. Consequently, it is commonplace for a franchisor to impose standards on its franchisees, necessary under the federal Lanham (Trademark) Act to protect the consumer. Such standards are essential for a franchisor that seeks to ensure socially desirable and economically beneficial oversight of operations throughout its network. These standards allow franchisors to maintain the uniformity and quality of product and

¹ 2022 *Franchising Economic Outlook*. Provided by FRANdata. (2022)

² Joseph H. King, Jr., *Limiting the Vicarious Liability of Franchisors for the Torts of Their Franchisees*, 62 *Wash. & Lee L. Rev.* 417, 420-21 (2005).

³ FRANdata research. (2021).

⁴ Kevin M. Shelley & Susan H. Morton, “Control” in *Franchising and the Common Law*, 19 *Fran. L. J.* 119, 121 (1999-2000)

⁵ Paul H. Rubin, *The Theory of the Firm and the Structure of the Franchise Contract*, 21 *J. Law & Econ.* 223, 226 (1978).

service offerings and, in doing so, to protect their trade names, trademarks and service marks (collectively the “Marks”), the goodwill associated with those Marks, and most importantly, the protection of the consumer. Because the essence of franchising is the collective use by franchisees and franchisors of Marks that represent the source and quality of their goods and services to the consuming public, action taken to control the uniformity and quality of product and service offerings under those Marks is not merely an essential element of franchising, it is an explicit requirement of federal trademark law.

I came into franchising after starting my career in computer programming for boutique insurance firms specializing in Section 125 (cafeteria plan) benefit administration. I was looking for the next step in my career and ready for a lifestyle change that allowed me to be with my family over the holidays, and I found a job description matching my technical expertise that came up for The Cleaning Authority. I assumed they would be behind the ball on technology because they focused on residential house cleaning. What I discovered couldn't have been farther from the truth. In 2013, this company was more sophisticated, more invested in technology, more aware of consumer behavior than I had ever seen. It was a franchisor. From that moment, I was hooked.

The driving force behind the WHY of the technology I was developing was to help franchise owners – to help them do what they do better, faster. It was from the franchise owners that we found our best ideas to make the business scalable, to improve offerings and marketing programs. As I now lead that organization that I joined as a computer programmer, I can tell you to this day that is exactly the same magic and perspective that makes a franchisor great. I took that same foundation – of listening to franchise owners and learning from them – with me as I developed and founded my own franchise concept. In 2013, I was asked by one of the founders of The Cleaning Authority to work with him on a new business venture – to franchise a business that provided senior living referral services. In August of 2013, we began the journey of drafting the Operations Manuals, the software system and the marketing programs, filing the FDD in April of 2014. Within 4 months, we had our first new owner training class.

Franchising creates opportunities for people of all backgrounds

In addition to my personal story and what I've seen firsthand, I'd like to spell out the incredible opportunities that franchising provides – whether it is in the form of entrepreneurship, job creation, or uplifting communities, the business model is uniquely positioned to make a difference.

In a recent study, Oxford Economics found that franchising offers a path to entrepreneurship to all Americans, but especially to minorities and women. The study found that the industry provides better pay and benefits than non-franchised businesses. In addition, franchising offers entrepreneurial opportunities that would not otherwise be available, especially to women, people of color, and veterans.⁶ On average, franchises report sales 1.8 times as large and provide 2.3 times as many jobs as non-franchise businesses. Sales and jobs in franchised businesses exceed non-franchised businesses across all demographic cuts, including gender and race. For example, Black-owned franchise firms generate 2.2 times as much in sales compared to Black-owned non-franchise businesses, on average.⁷

Franchising democratizes business ownership for people of all backgrounds. There is a higher minority ownership rate among franchised businesses than in non-franchised businesses: 30.8

⁶ *The Value of Franchising. Oxford Economics (2021).*

⁷ *The Value of Franchising. Oxford Economics (2021).*

percent of franchises were owned by minorities, compared to 18.8 percent of non-franchise businesses. Asians, Blacks, Hispanics, and “other” minorities had a higher rate of ownership of franchises than non-franchised businesses in 2012, while American Indians and Pacific Islanders had roughly the same ownership rates among franchised and non-franchised businesses. Asians owned 11.8 percent of all franchises, compared to 6.3 percent of non-franchised businesses. Hispanics owned 10.4 percent of all franchised businesses, compared to 7.2 percent of non-franchised businesses. Blacks owned 8.0 percent of all franchised businesses compared to 4.7 percent of non-franchised businesses.⁸

When asked what factors help to enable franchised businesses to reach a larger scale, respondents discussed what was most useful in franchisor support. Results suggest the important areas are franchisee training, meetings and events, and technology platforms. Even in areas where franchisor support is less widespread, such as access to capital support (received by 42% of respondents), the positive effects of the business model are striking. Some 21% of respondents report being capital constrained when starting their first franchise business and that being a franchisee provided them with access to capital. In addition, 32% of all respondents report they would not own a business if they were not franchisees. This proportion is even greater among both female owners and owners for whom a franchise was their first business (39%).⁹

The study also found that franchises are locally owned and tend to keep resources in the local community. Unlike the multi-unit company-owned business model, franchises allow local franchisees to buy and own the units they operate. By doing so, franchisees become small business owners, who live and work in their local communities. The brands they represent largely recruit and train local residents rather than bringing in workers from other parts of the country.

In my own experience, the Cleaning Authority has impacted hundreds of thousands of lives. Each one of our professional housecleaners has a clear path to career advancement. We provide training at all sections on the path: from cleaner, to certified cleaner, to trainer, to inspector to assistant manager to manager. In the past year, we have had two managers purchase the Franchise Location from their owner. A majority of our workforce is female and giving these women and their families stability and growth is one of my passions. We are rolling out new personal and professional development courses to employees including Personal Finance, Customer Service, and Internet Skills. These will be made available, free of charge to all employees of The Cleaning Authority franchise owners.

I am so proud of what The Cleaning Authority has accomplished for the more than 200 communities we operate in. Through our TCA Cares program, which was designed by franchise owners and facilitated by the franchisor, we have had 12 food drives, collecting over 1 million pounds of food—equal to 894,000 meals to over 600 food banks within our communities. Last year, our first coat and outerwear drive last year we saw almost 10,000 articles of clothing donated. We also award ten \$1000 scholarships to employees and their dependents of The Cleaning Authority to align with our mission to positively impact the quality of life of the people we employ.

There is no doubt that the franchise model therefore encourages local employment and wealth-sharing with local communities. The franchise census suggests franchisees purchase 21% of their inputs from local suppliers, indirectly contributing to their local economies through their supply chains. Over a third of respondents (36%) purchase at least 25% of their intermediate goods

⁸ *Franchised Business Ownership by Minority and Gender Groups. IFA Foundation (2018).*

⁹ *The Value of Franchising. Oxford Economics (2021).*

locally. In addition, some 65% of franchisees give to local charities according to the franchise census. This is in line with findings that suggest 66% of all small businesses do so. Among donors, franchisees donate an average of 6% of their profits (also in line with small businesses' data).¹⁰

The IFA estimates that U.S.-based companies operating as franchises jointly donated a total of \$1.5 billion to charity in the year before the pandemic and raised over \$900 million over the same period. Some 18 million hours of volunteering were sponsored by franchised businesses in 2019, which are worth hundreds of millions of dollars to society more broadly, and I'm so proud of the examples that my own company can show to this.

The state of franchising in small business economic recovery

In 2017, I became a franchise owner myself. I knew the system backward and forward, and I knew all I had to do was follow the playbook. Being a business owner is one of my proudest accomplishments, and The Cleaning Authority of Harrisburg, Pennsylvania has changed my life and my family's life. I am able to make decisions that benefit myself, my family, and my employees. I would have never thought I would be in the position that I find myself in. Being a franchise owner is not easy, just like certain jobs – like being a senator – aren't for everyone. The week before COVID hit, my business hit a record-breaking revenue milestone. I was on top of the world. Then the world spiraled out from under me. We all know there was no playbook for that.

When the COVID pandemic hit in March 2020, I watched my revenue that I worked so hard to build drop in half, then in third, then to 1/5 of my average weekly revenue in just six short, but very long and gut-wrenching weeks. I watched my life's investment plummet in value. I eyed my children's college education fund. I called my bank to get a line of credit against my house. I was devastated, until Congress and the Small Business Administration (SBA) stepped in. Without the waiver of affiliation rules for franchise owners like me that was included in the CARES Act and Paycheck Protection Program, my employees would have suffered. Because of what Congress and the SBA did, I was able to keep every single person on my payroll, even without customer payment coming in. Because of what the Congress and the SBA did, Genelle Rice, an employee who has been with me on this journey for 6 years, was able to tell her family, "Don't worry, The Cleaning Authority is taking care of me." I will be forever grateful to the U.S. Congress for its work on PPP.

Obviously, I was not alone. The COVID-19 pandemic battered small businesses in historic ways. By August 2020, within the first six months of the COVID-19 outbreak, an estimated 32,700 franchised businesses had closed; 21,834 businesses were temporarily closed, while 10,875 businesses were permanently closed.

We are proud of the growth that franchising has had and its role in the economic recovery. Franchising had an exceptional year in 2021, and 2022 looks to be another strong year of recovery. Bolstered by both the strengthening labor market and steady consumer spending, franchising is expected to continue to expand, trending upwards with the United States' overall economic progression, but the pace of the growth in 2022 is most likely to moderate, due to the current headwinds in the economy.

Some key predictions for 2022 include: Franchises' GDP contribution to the overall economy will remain stable at 3% in 2022, but the growth rate is likely to slow to 5.7%, still higher than the pre-pandemic level, to a total of \$501 billion. Franchise employment is forecast to grow at a slightly

¹⁰ *The Value of Franchising. Oxford Economics (2021).*

lower rate of 3.1% to a total of 8.5 million jobs, a net gain of almost 257,000 jobs compared to 2021. The output of franchise businesses in nominal dollars is forecast to improve by 4.9% to \$826.6 billion in 2022. It is forecast that franchising will end the year with more than 792,000 establishments, adding a net gain of 17,000 new locations, with a marginally lower growth rate of 2.2%.¹¹

This recovery is remarkable, and that's largely in thanks to the hard work of these local business owners who prioritized their workers and did everything they could to keep their businesses on solid footing with the backing of a strong brand – and much of it would not have been possible without the Paycheck Protection Program (PPP) program that the IFA helped secure for franchised businesses, and the support from the SBA through it all.

Franchising is a symbiotic relationship between franchisors and franchisees

Founding a franchise concept is without a doubt the hardest thing I have done. I can't imagine how we would have done it with even more challenges and regulations in our way. Promoting access to capital is one of the most important ways lawmakers can ensure entrepreneurship opportunities are available to the next generation of people from all backgrounds.

The IFA is very supportive of SBA loan programs. These loan programs are essential to helping small businesses get off the ground, giving the opportunity to those who may not have access to capital realize the American dream. While legislation intended to ensure more transparency and disclosure is well intended, it will end up hurting those who need access to capital most. The SBA is also not the appropriate forum for increasing disclosure requirements on franchisors – that role resides with the Federal Trade Commission (FTC) and with state franchise laws.

The Federal Trade Commission authorizes and regulates the sale of franchises in the U.S. and defines a "franchise" in part as "any continuing commercial relationship or arrangement" whereby the franchisor promises that the franchisee "will obtain the right to operate a business that is identified or associated with the franchisor's trademark."

In 1978, the FTC published the Franchise Rule, which provides prospective purchasers of franchises information they may use to weigh the risks and benefits of a franchise investment and requires franchisors to provide potential franchisees with specific items of information about the offered franchise, its officers, and other franchisees. The IFA supports this rule, as it has helped empower current and prospective franchise owners by requiring clear and consistent disclosure of information at the outset of all franchise relationships. The IFA also supports improvements to the Franchise Rule, and has recommended a number of steps the FTC should take to improve the rule for franchising.¹²

Importantly, the Franchise Rule mandates that a franchisor "exert a significant degree of control over the franchisee's method of operation."¹³ However, many state independent contractor laws require businesses to classify workers as employees unless they are "free from control" and direction while performing their work. Taken in a literal sense, this requirement would ignore the

¹¹ *Franchise Economic Outlook. International Franchise Association (2022).*

¹² IFA comments on FTC Franchise Rule: https://www.franchise.org/sites/default/files/2019-05/IFA%20Comment%20on%202019%20FTC%20Franchise%20Rule%20Review%20-%20Final_1.pdf

¹³ *Ibid.*

realities of the franchise model, and so the conflicting “control” requirements of the FTC’s Franchise Rule and the Lanham Act must be viewed as preemptive.

The success of the franchise model hinges upon smart and effective regulation. Indeed, the IFA’s founders worked cooperatively with the FTC staff during the 1970’s to develop the regulatory model that has governed franchising for almost half a century. Since 1978, the FTC Franchise Rule has served as an important tool to require franchisors to prepare and provide an extensive pre-sale disclosure document to prospective franchisees. That policy decision to favor pre-sale disclosure instead of rigidly prescriptive regulation has led to the franchise sector flourishing with thousands of franchise companies in more than 230 industries contributing considerably to entrepreneurship as well as the economy’s growth and vitality.

The Franchise Rule is currently undergoing the periodic decennial review by the FTC and is the single most important government regulation affecting franchising. By requiring clear and consistent disclosure of information at the outset of all franchise relationships, and through its evenhanded federal application, the existing rule sets the stage for franchise brands and franchise business owners to succeed together.

The Lanham Act is the federal law regulating trademarks, service marks, and unfair completion, and it mandates that owners of trademarks must “maintain[] sufficient control of the licensee’s use of the mark to assure the nature and quality of goods or services that the licensee distributes under the mark.”¹⁴ Moreover, because the Lanham Act provides that a trademark can be deemed “abandoned” when “any course of conduct of the owner . . . causes the mark . . . to lose its significance,”¹⁵ franchisors have a strong incentive to control the nature and quality of the good or services sold by their franchisees. As a result, franchisors are compelled to establish and monitor brand standards and provide global oversight of their franchisees. Likewise, it is imperative that franchisees protect their franchisors’ brands, and the trademark value of those brands. A franchisee, functioning as an independent operator under a Brand License, is trusted and relied upon (by the franchisor) to protect the trademark value in implementing brand standards, and to exercise day-to-day management over the operation, since the franchisor is not present at every individual franchise location. Because franchising requires the collective use by franchisees and franchisors of Marks, all stakeholders affiliated with a brand collectively share risks and rewards.

For example, if a franchisee fails to take adequate steps to protect the brand or otherwise engages in an action that injures the brand’s reputation, the damage inflicted on the brand impacts all of the brand’s stakeholders, including all other franchisees and the consuming public. With that being the case, it is essential to franchising that all the stakeholders understand the expectations for brand protection standards and take all necessary action to ensure that those standards are met.

Furthermore, these rights and obligations are enunciated in well-drafted franchise agreements and reviewed in advance under a prescribed set of mandated disclosures. Franchising is also subject to joint employment tests under multiple federal laws. Under the Fair Labor Standards Act, courts around the country have issued divergent rulings on the joint employer issue, most of which purport to apply the Department’s previous, outdated joint employer regulation. The number of different standards and factors employed in each test by various courts has bewildered and frustrated employers seeking to operate franchise businesses efficiently and profitably, without inadvertently creating joint employment. By way of examples only, the Second Circuit has applied a

¹⁴ 15 U.S.C. § 1064(5)(A).

¹⁵ 15 U.S.C. § 1127.

six-factor test in *Zheng v. Liberty Apparel Co.*, while the Third Circuit applied four different factors in *Enterprise Rent-A-Car Wage & Hour Employment Practices Litigation*, the Fourth Circuit utilized a different six-factor test in *Salinas v. Commercial Interiors, Inc.*, while various cases in the Seventh Circuit have applied “economic realities” tests (that are indeterminate in nature), and the Eleventh Circuit applied an eight-factor test in *Freeman v. Key Largo Volunteer Fire and Rescue Dept., Inc.* Adding to this complication, under federal civil rights laws, courts have applied (again, not always uniformly or consistently), a multi-factor “common law” test.

We understand concerns about recent reports about fraudulent actors in the franchise space, and the IFA has expressed support for the actions taken by the FTC, the Department of Justice and state regulators to prosecute bad actors. The fact that brands are being held accountable for abuses of the franchise system shows the current system is working, not that new regulatory measures are needed. If anything, the existing regulators simply need more resources to further enforce existing law and improved data that would paint an accurate picture of any discrepancies in franchise loan performance at the SBA compared with non-franchise businesses. In other words, the actions of a few bad actors should not lead to new laws that will impact the overwhelming majority of the more than 3,000 franchise brands like ours, and the hundreds of thousands of franchisees, who support the current regulatory framework.

Additionally, the notion that franchisees like me are being “squeezed” by brands is simply not accurate. According to Franchise Business Review, an independent research firm that has surveyed 30,000 franchisees annually for 17 years, franchisee satisfaction is at an all-time high, with 80 percent of owners reporting they would recommend their franchise organization to others.

We urge the committee to keep in mind that multiple federal statutes currently provide the rules of doing business by the franchising method. Indeed, franchising is already a “heavily regulated” method of doing business, as it is fundamentally governed by the FTC Franchise Rule, the Lanham Act and multiple joint employment tests. In addition, Maryland is one of about 15 states in the United States that requires “registration” of franchise offerings. Before you offer or sell any franchise in Maryland or to any Maryland residents, you must first register your franchise offering with the Securities Division, Office of the Attorney General.

By requiring clear and consistent disclosure of information at the outset of all franchise relationships, and through its evenhanded federal application, the existing rules allow for transparent information to be provided to prospective franchisees so that they can make informed decisions before entering commercial relationships. As a result, franchise brands and franchise business owners have succeeded together. The appropriate regulatory framework for a sector as diverse and complex as franchising must allow all stakeholders in the arrangement to have proper access to information and avoid changing the balance, for the betterment of all stakeholders concerned, including franchisors, franchisees, borrowers, and lenders.

Upholding the highest standards is critical to the success of franchising. That is why the International Franchise Association has prioritized franchise education and certification to elevate the performance of franchising. Last year, the organization created the IFA Standards Task Force to ensure that IFA members are credible and meet its membership standards, while more importantly, examining methods to improve the information available to prospective franchisees. Working together, with government as a partner not an adversary, the franchise business model can continue to improve and benefit franchisors, franchisees, and consumers alike.

You might have heard an old saying: If you want to go fast, go alone. But if you want to go far, go together. I believe America needs to go far. I believe we need to go together. And I believe we can do it by keeping franchising alive and well.

Thank you for the invitation to appear today.

Chairman CARDIN. Well, thank you very much for your testimony.

Mr. Tipton.

STATEMENT OF BRYAN TIPTON, OWNER, TIPTON INVESTMENTS, NICHOLASVILLE, KY

Mr. TIPTON. Chairman Cardin, Ranking Member Paul, and members of the Committee, I would like to thank you for having me here today for this hearing. My name is Bryan Tipton, and I have been in the restaurant and bar business my entire adult life. I am now a proud fast food franchisee and I have been for many years. I hope that my experience can be of benefit to this meeting today.

I would like to start by saying that when I pursued a franchise I knew that before I ever opened the door of a restaurant that I would have in my particular brand at least 50 years of experience at my fingertips. As it turned out, I was right. I also knew that I would have buying power and support that I would have never had on my own. And as a group, we can advertise and promote our company in ways otherwise unimaginable.

Even before the pandemic, the restaurant business has been a very tough business. Everyone knows that lately it has been even tougher since the pandemic. It is a retail business that in most cases is over 16 hours a day with strict regulations, health codes from every health department and city and county in America. As a franchisee of a large restaurant group, I can tell you there is already a lot of oversight, paperwork, reporting, et cetera, required to the franchisor, and my process with my franchisor was extremely transparent.

The legislation discussed today seems to be addressing a problem that does not exist. I just cannot imagine adding more red tape to it and with government regulations and oversight. It would only add to the cost of franchising at a time when franchising is helping navigate an already difficult business environment. I just do not see the need.

I would also like to mention that in the beginning of the pandemic there was a lot of uncertainty. Many, if not all, business owners were very scared and unaware of the future, especially restaurant businesses. A lot of restaurant owners took PPP assistance, but I think now we are seeing terrible consequences of this program and a lot of other government giveaways, and now what we thought would help is hurting us in a big way. I did not take a second PPP or a Restaurant Revitalization Grant, and if I had it to do over again, I would not have taken PPP.

Because of these programs, there are record levels of inflation and the biggest labor problem in my career. Industrywide, in almost everywhere in this country, they have seen the same problems since the beginning of the pandemic—unemployment due to stimulus. There have been good intentions, but I certainly do not think that more government intervention is going to fix it now.

Restaurants have been resilient, and if they are not making it now, there is likely other reasons for it. Additional grant funding or government-backed loans will only further the inflation problem. The government needs to get out of the way of business owners.

At the same time, the taxpayers taking on risky business loans is not an answer either. Most small business owners' needs, including my own, can be met in the private lending market. More red tape to navigate, on the other hand, is the last thing that my business or any other small business needs right now.

Thank you.

[The prepared statement of Mr. Tipton follows:]

Testimony of Bryan Tipton
Owner, Tipton Investments

U.S. Senate Committee on Small Business and Entrepreneurship Hearing
“Small Business Franchising: An Overview of the Industry, SBA’s Role, and Legislative Proposals”

Chairman Cardin, Ranking Member Paul and Members of the Committee, I would like to thank you for having me at today’s hearing. My name is Bryan Tipton I have been in the restaurant and bar business my entire adult life. I am now a proud fast food franchisee and I have been for many years. I hope that my experience as an operator can be helpful to this committee today.

I would like to start by saying that by pursuing a franchise, I knew that before I ever opened the door of a restaurant, I would have over 50 years of experience that the Arby’s franchise has gained at my fingertips. As it turned out I was right. I also knew that I would have buying power and support that I would never have on my own and as a group we are able to advertise and promote our company in ways otherwise unimaginable.

Even before the pandemic, the restaurant business has been a very tough business and everyone knows that lately has been even tougher. It’s a retail business that in most cases is open over 16 hours a day with strict regulations from health codes from every health department in every city and county in America. As a franchisee of a large restaurant group, I can tell you there is already a lot of oversight, paperwork, reporting etc. required of the franchisor and my process with my franchisor was extremely transparent. The legislation discussed today seems to be addressing a problem that doesn’t exist. I just can’t imagine adding more to that in the form of government regulations and oversight. It would only add to the cost of franchising at a time when franchising is helping navigate an already difficult business environment. I just don’t see the need.

I would also like to mention that in the beginning of the pandemic there was a lot of uncertainty. Many if not all business owners were very scared and unsure of the future. A lot of restaurant owners took PPP assistance but I think that we are seeing the terrible consequences of this program and a lot of other government giveaways and now what we thought would help us is now hurting us in a big way.

I did not take a second PPP or a Restaurant Revitalization grant and if I had to do it over again, I wouldn’t have even taken any PPP. Because of these programs there are record levels of inflation and the biggest labor problem in my career. Industry-wide and almost everywhere in this country they have seen the same problems since the beginning of the pandemic: unemployment due to stimulus. There may have been good intentions but I certainly don’t think that more government intervention is going to fix it now. Restaurants have been resilient and if they are not making it now, there is likely another reason for it. Additional grant funding or government-backed loans will only further the inflation problem.

The government needs to get out of the way of business owners. At the same time, the taxpayer taking on risky business loans isn’t the answer either. Most small business owner’s needs including my own can be met by the private lending market. More red tape to navigate, on the other hand, is the last thing that my business or any other small business needs right now.

All opinions expressed here are my own, and are not necessarily those of organizations I am affiliated with.

Senator PAUL [presiding]. Thank you all on the panel for your testimony.

Professor Yelowitz, President Biden and others have argued that corporate greed causes inflation. Biden quotes 17 economists to also argue that Build Back Better, a couple trillion dollars' worth of deficit spending, will reduce inflation. Speaker Pelosi recently blames inflation on low unemployment. I was wondering if you could give us a little review, a little Economics 101, on what actually causes inflation.

Dr. YELOWITZ. Well, I am not a macroeconomist, so I will say that off the bat. But basically, when supply and demand are out of whack, then prices will adjust. And in the labor market, for example, we see a worker shortage, wages are rising, businesses are competing for workers, yet not being able to get them even without, for example, higher minimum wages. And so in a sense, prices adjust. They are a market signal that basically says something about scarcity, and that is likely what is going on now. We just have all sorts of interruptions in the economy, and that probably is what is causing the higher prices that we are seeing.

Senator PAUL. Do you think deficit spending, increasing deficit spending, makes inflation less or more?

Dr. YELOWITZ. It certainly would increase it.

Senator PAUL. Mr. Tipton, we have been talking some about business loans, government involvement, but there are many other factors of life and what government either does to you, for you, or against you that affects how your business—how well your business succeeds. In 2017, we passed a tax reduction, letting business owners keep more of what they earned. Did you see any effect in your business? Did the tax rates allow you to expand any in your business?

Mr. TIPTON. Yes. Obviously, when there is more going in the pocket of the business owner, they have more capital to grow and spend. In my company, we enjoyed that benefit then.

Senator PAUL. I have no further questions. I thought somebody just came in, but, no. We will wait for one moment, and the Chairman will be back, and we will have some more questions in just a moment.

[Pause.]

Senator PAUL. While we are waiting, I do have another question for Mr. Tipton. Your experience as a franchisee and dealing with a franchise, you know, with a parent company—do you see it in your experience as being adversarial, or do you see that your interests are aligned between the franchisee and the franchisor, or do you see it as a relationship that works or a relationship that needs the government to be involved in a bigger way?

Mr. TIPTON. Well, certainly do not need the government involved. My process with my franchisor was very transparent, and the relationship is very good. It was good then, and it is good now and always has been. I have been through the process with more than one national brand, and it was the same. It was very good, very transparent. As a matter of fact, both were so transparent that there was a lot, a lot of information, a lot, a lot to take in. Nothing was left out.

Senator PAUL. So I guess you get the benefits of the name of the restaurant chain that drives customers in. You get benefits of cheaper cost of goods. I guess you get food and supplies for the restaurants come through a purchasing agreement with the parent company. Is there also availability of credit through the company as well as far as borrowing?

Mr. TIPTON. I am not sure. I have never used the company for financing. I have always—that has always been done in private banking industry. And if—in my opinion, if you are doing the right stuff, that is not going to a problem.

Senator PAUL. So you did not utilize small business loans in starting yours? You utilized just the private banks and banking system?

Mr. TIPTON. No. And I do not understand why—I do not understand why you would. If you are doing the right thing, the private banking industry is going to be there.

Senator PAUL. Well, the difference also is that there is a feedback loop. If you borrow from government and government puts out a thousand bad loans, who is going to replace the people in government and say they are not doing a good job?

If you live in Richmond, Kentucky, and your bank does a thousand bad loans, my guess is that way before you get to a thousand somebody loses their job or the bank goes out of business or you have to have, you know, some sort of feedback loop.

And this is essentially the difference between government and private sector and one reason why many of us will argue that the private sector, unless it absolutely is not working, that we should really try to do almost everything within the private sector because you have that feedback loop that breeds excellence, and that is basically the profit motive.

Mr. TIPTON. I would also say that if you cannot get financing through the private sector and you need to go to SBA, then you are not—obviously, you are not doing something right anyway.

Senator PAUL. Thank you.

Senator Ernst.

Senator ERNST. Thank you, Mr. Chair, and thanks for the witnesses for coming in front of us today for this hearing.

The franchising model system has provided so many with the opportunity to independently run a small business. We see this all across Iowa, and as part of my 99-county tour, I have heard from many of those franchise owners throughout my State. These franchising opportunities are providing entrepreneurs with a proven business model, a recognizable brand that offers a built-in customer base, and the potential for fast growth.

In Iowa, franchises contribute \$4.1 billion to the economy and over 95,400 jobs. These small businesses, like all other small businesses throughout the country, are vital to the economy. That is why I am so excited to have the opportunity today to discuss the role that the SBA, the Small Business Administration, plays in small business franchising as a whole.

So if we could start with you, Dr. Yelowitz, I appreciate you coming in today to discuss these small business franchises. In your testimony, you had mentioned that SBA loans were a strong contributor to job growth by providing access to capital for our small busi-

nesses. How can SBA lending programs be better utilized for job creation and wage growth, especially in the areas like mine, our very rural areas?

Dr. YELOWITZ. Basically, SBA loans, the studies that I have reviewed show that there is some job growth from those loans. On average, around 3 to 3.5 jobs are created per million dollars of loan. Those studies do not distinguish between franchises versus independent businesses, and so probably my biggest take would be to not single out franchises for any different kind of regulation than for any other sort of business.

Senator ERNST. No, thank you. We just know how important it is to have access to those loans and certainly to promote job creation and wage growth.

Now in your testimony, you also mentioned protecting the Protecting the Right to Organize Act or the PRO Act, which would codify into law an expanded joint employer standard, where franchisors can be held responsible for actions taken by their franchisees. You say that this would essentially eliminate the entire concept of franchising as a business model. Can you talk about the effects that that the joint employer standard would have on small businesses and our consumers as well?

Dr. YELOWITZ. The PRO Act has several provisions in it, the joint employer standard and the so-called "ABC test," which will raise the cost of doing business in terms of the franchisor-franchisee relationship. If it increases costs, then what will likely happen is that there will be fewer franchises out there. That, in turn, will lead to less competition. And as we know, less competition will lead to price increases in an economy where we already have as high of inflation as we have seen in 40 years.

Senator ERNST. Right. Yes, thank you so much. I know it is extremely concerning to so many across the State of Iowa and I am sure in many other areas as well.

And, Mr. Tipton, thanks again for appearing in front of us. In your testimony, you had mentioned how record levels of inflation caused by Federal spending is impacting small business supply chains. Inflation has created a hidden value-added tax on producers, and the Producer Price Index reached 10 percent over the last year this month. And can you talk a little more about the impact that inflation has had on producers and what that means for prices facing our consumers?

Mr. TIPTON. Well, it has affected every part of the business, every part of the supply chain. In my brand, we have seen increases on every single part of the company, from all supplies, everything from fuel cost, extras, you name it. Across the board, there has been increases in everything. And that has led to across-the-board price increases from the brand to the consumer, which we have already implemented one price increase just a few weeks ago and will likely see more at this rate.

Senator ERNST. Yes, I would agree. Now for all of our witnesses as well, with the cost of doing business for our small businesses and our franchisees, do you see this as being transitory? And if it is not transitory, at what point do we ever bring those costs back down, and how does that happen?

Mr. TIPTON. Well, I do not know if I know the answer to that, but I do know that usually, as we all know, when prices go up, a lot of times they do not come down. And I am a little fearful of that because the inflation numbers that we have seen have taken a lot of profit out. You know, we tried to eat a lot of this to stay competitive. A lot of fast foods brands were trying to do that, but it was just too much. Still had to raise prices. And we are still—you know, profit margins are far less today than they were this same time last year.

Senator ERNST. Thank you. Any other panelists?

Mr. EMERSON. Yes, I would like to say I think the costs are transitory. I mean, things go up; things go down.

And I think that some of the concerns about the PRO Act are overstated. I think that a lot of the issues arising out of a concern about the gig economy are justified, and there are questions of how it would actually be implemented to try and accommodate the fact that we are in a much different era than we were even 10 or 20 years ago. But to reflexively, in effect, say this is going to kill franchising is, I think, overblown.

I believe that a lot of the concern has been generated by, of course, what is going on in one or two states and one or two provisions, or at least suggested provisions, which may need to be tweaked. But to not recognize that the economy is not the same and that franchisees are, in some systems—or would-be franchisees, depending on how you classify them—are in a different position than sort of the old fashioned standard. So whether you call them an employee—or in one of my articles I talk about them as dependent contractors, not independent contractors—can vary.

A lot of the issue really for the systems on a macro level, I think, is that some franchise systems are doing very well, their franchisees are doing well because of that and they justifiably, as Mr. Tipton clearly is, are proud to be and happy to be in a system, but I am concerned that the ones that are not doing that well are actually sort of a drag on franchising generally. I mean, that is what led to the first real legislation in America, in California and other states, was the history of problems in the 1960s, early 1970s, with people that were basically churning franchises. And I am not saying that is happening in most systems, but clearly what Senator Cortez Masto was referring to in some franchise network systems was such a thing.

So I do not see how the proposed bills really would necessarily have a dramatic impact on a cost. I think a lot of the work that is being done to furnish data is already cooked into the system and it is just a question of doing it more effectively. It is not so much there is too much information. There is a lot of information. But it is just that the accessibility of it is not that easily available.

And that is why I use the metaphor of a fire hydrant or something just spewing out all this information, but it is not really that well organized. And a lot of prospective franchisees throw their hands and say, well, I think I feel comfortable. And it really should not be like that. They should have better access to the information.

And as I understand it, a lot of franchisors are in favor of that. They do not have a problem with that information—

Senator ERNST. Thank you. I want to offer the opportunity to other panelists as well. Thank you.

Mr. EMERSON. Yes, I understand. Thank you.

Senator ERNST. Yes, please.

Dr. YELOWITZ. One thing that I think will be important to emphasize is that you spoke about some of the provisions from the PRO Act, which is quite a bit different than information disclosure. And what I would point out about information disclosure is there are thousands of brands out there that compete with each other in terms of providing information, and those that are providing transparent products will find more takers. So I think the market as a whole, the private market, will in a sense solve many of these issues.

And there might be stories about one of two brands, but there are thousands of brands out there. And remembering that this regulation does not only affect the one or two brands, or several brands, where there are these stories, but all brands is something really important to consider.

And again, your question about joint employer, about the ABC test, those sorts of things, feels quite a bit different than the information disclosures.

Senator ERNST. Very good. Thank you.

Well, I will yield back my time. Thank you very much. Thank you, Mr. Chair.

Chairman CARDIN [presiding]. Thank you. As I hope was explained, there are votes that are going on. So I went over to cast my vote. I am sorry I missed some of your comments. There will be a second vote on in about 20 or 25 minutes from now, but we are going to try to continue the hearing.

I just really want to respond briefly to some of the comments that have been made in regards to inflation, cost, and small businesses. Ms. Stapf, I appreciate your acknowledgment in your written testimony as to the importance of the PPP program to keep businesses afloat. The PPP program was created by bipartisan leadership in the U.S. Congress. I was proud the role that the Small Business Committee played, working with Senator Rubio, Senator Collins, Senator Shaheen, and myself in drafting the Paycheck Protection Program.

And then in the American Rescue Plan, we fine-tuned it so that we could really tailor it to the small businesses that needed it the most. And the statistics from 2021 indicate that we were able to get to the smaller small businesses, to those in underserved communities, that we were able to get to those that were so desperate.

And your observations are similar to the observations that I have received in going through my small business community. On Small Business Saturday, I was in Annapolis visiting small business owners who told me, literally, they would not be open today but for the help they got in regards to the small business aid programs as a result of the Coronavirus packages.

So I just want to dispel the concept that what we did to help small businesses and keep them alive, keep our economy moving, prevent from going into a deep recession is not why we have high prices today. High prices are a result of many factors, including a supply chain challenge in which one of our colleagues, Senator

Cantwell, has worked on legislation to innovate and manufacture here in America, that we are going to be going to conference as a bipartisan bill to try to deal with supply chain issues, that will deal with some of our challenges on cost as well as some of our workforce challenges, for example, the cost of childcare, keeping too many women particularly out of the workplace.

So we have a game plan to deal with the cost centers, but I just really do not want to blame the help that we have given to small businesses as anything other than helping our economy survive the greatest pandemic in a hundred years. And I am proud of the work that we did, near unanimous. We had a few members of the Senate who disagreed with the program, but by and large, this has been a collective effort in order to keep our economy moving during the Coronavirus.

So I want to get back to the franchise issue because I do think the franchise model is a critically important model for our economy, and I recognize that. I have recognized it from the beginning. But it does have certain vulnerabilities because of, in cases, the contractual relationship between the franchisor and the franchisee.

So if I might, Professor Emerson, start with your view, you said favorable things about the need for certain congressional action in order to deal with making information available to potential franchisees. Could you elaborate as to where you think the greatest priority should be placed in providing information to a franchisee? We know that the legislation deals with financial information and failures, et cetera, but where do you think there is need for more definitive regulation?

[No audible response.]

Chairman CARDIN. You are on mute, I think, Professor. We still cannot hear you.

Mr. EMERSON. Okay.

Chairman CARDIN. We hear you now.

Mr. EMERSON. I am unmuted now?

Chairman CARDIN. Yes, you are Okay.

Mr. EMERSON. I knew that would happen. Now I think that the biggest problem, as I have said, really is there is a lot of information out there. And a lot of it—I think if franchisees, prospective franchisees, put in the time they can get better information. But the ability to compare to other franchises that they may be looking at, to cross into other industries and look at them, to kind of evaluate their costs, not being franchised but otherwise investing in some other opportunity, is very difficult for them to do because of the way that the data is just sort of presented.

And I think in time this will probably become easier for people to handle, but anything that can be done by the FTC, the IFA, the SBA or others, or could be facilitated by an act of Congress to make that data available would be very useful. I think that that is one reason I think S. 1120 could be so helpful is what it might provide in terms of the ability to give that more data to prospective franchisees.

A lot of the things I outlined in my written statement are more problems substantively, I think, in terms of some of the things in a franchise agreement or the procedures for dealing with them. And anything at the FTC level or the SBA level that could give

more information to franchisees about what it is they are dealing with would be good. But for now, I do not think Congress has really shown that much inclination going into substantive mode. If Congress wanted an act on franchising, that would be entirely a different matter.

Chairman CARDIN. Thank you.

Ms. Stapf, you can give us a unique perspective, both as a franchisor and a franchisee. So tell us what information is the most useful to have available to a potential franchisee in deciding whether to move forward with the business opportunity?

Ms. STAPF. Yes, thanks. Yes, outside of the leadership and the history of the brand, I think the Item 19 is obviously very important for prospective franchise owners. I also believe that Item 19 is the next best place to start because that will allow a prospective franchise owner to see the health of the brand, openings and closures, and then be able to have full access to all of the other franchise owners and then can conduct their due diligence. So those are the two areas of the FDD.

Chairman CARDIN. So let me turn to how the SBA can be helpful to a franchisee. In what areas do you think the SBA could improve its ability to help franchisees in making decisions on franchise agreements or to be able to operate as a franchisee?

Ms. STAPF. Yes, so I think that the SBA directory might be a good place to start. So this was in conjunction with the IFA was formed, and it set criteria with the SBA. And one way that we could make—one thing that we can look at is maybe expanding that criteria.

Chairman CARDIN. And in regards to the financial tools that are available through the SBA, from the numbers we are looking at, it looks like there is a pretty active use by franchises of the tools at the SBA for financing. Do you have any suggestions as to where you think the priorities should be?

We have the 7(a) program, obviously. We have the smaller programs such as the microloan programs. We have the 504 program and refinancing. Is there a particular challenge that you see in any of those tools that we could fine-tune to help franchise owners?

Ms. STAPF. Well, I am honored that you would ask that. So just in my personal experience, traditionally a lot of our franchise owners use the express loan, and that has been just a bit of a challenge from a time perspective. I do not know if it is a backlog from PPP loans or what have you or the fact that we are a low-dollar loan because we do not have assets. We are a service brand. But we find that it is taking a considerable amount of time before our franchise owners get funded for their express loans.

Chairman CARDIN. We do find a general problem in regards to the loan programs at the SBA, that those that are smaller in dollar amount generally are not the priority of private financial institutions. They like larger loans, generally. They can do one loan rather than have to do three for the same number of dollars. They would rather just do one loan. So we do find a challenge in regards to the smaller amounts of loans, for the smaller numbers.

I take it that in the franchise world you have large franchisees and you have small franchisees. So you have different ones that qualify for the SBA programs. That is one of the reasons why there

is under consideration today the direct lending program by the SBA so that there would be no disadvantaged on the size of the loan that is being requested under the 7(a) program. There is also proposals to deal with the cost of the 7(a) loans, recognizing that for smaller companies that cost issue can become an obstacle for getting a loan.

Your observations seems to indicate that the smaller the loan it can be more challenging to get the attention of a private bank?

Ms. STAPF. Certainly, that is my observation. You know, I do not have obviously the proof of that, but I do feel that our loans are just taking an enormous amount of time where other more asset-heavy franchise systems are getting their loans quicker. So that would be great for us.

Chairman CARDIN. I would be glad to hear from any of the other panelists if you want to make some additional comments. We have the time. So, Mr. Tipton, do you want to add anything to the discussion.

Mr. TIPTON. Just off of what she just said, I do not know. I do not have the numbers or anything either, but maybe the loans may take longer because of the fact that they are no-asset loans. Maybe the due diligence in that is different. I do not know.

Chairman CARDIN. Professor Yelowitz, in regards to franchise businesses, are there particular challenges that you find in regards to the SBA tools that are available?

Dr. YELOWITZ. I think that Ms. Stapf and Mr. Tipton, being business owners themselves, probably are more expert on that. So I do not think that that is my wheelhouse.

Chairman CARDIN. Okay. Professor Emerson?

Mr. EMERSON. I would tend to agree with Professor Yelowitz.

The only thing I would add is my concern—and I cannot verify this—is information that is privy to the SBA in terms of the guarantee function, or lenders, but not available to the franchisee, the prospective franchisee itself, in terms of arranging for the loan to be approved. And that strikes me as, at least from an angle of equity, problematic. And there is at least people that think that that is a problem, certainly when you look at what Senator Cortez Masto's office filed. The information at least that franchisors are imparting information to help sales prospects get a loan but not providing that information to the franchisees, under some cloak of confidentiality, would be very troubling to me.

Chairman CARDIN. That is an important point. You know, that is one of—we are going to be in conversations with the SBA on some of these issues and try to work with them. I think much of this can be done administratively, as has been pointed out. So we will be working directly with the SBA to see whether we cannot deal with some of these issues through their practices.

And I agree with Professor Emerson. There is a lot of information out there, but if you are just starting a franchise business, you do not have deep pockets. You do not have a lot of people on payroll to be able to delve through all this information. It has got to be made available in a useful way.

And it is hard enough now to get through all of the requirements to get the loans and everything together to start a business. You do not have the resources to try to wade through all this informa-

tion and go through all this challenge in order to be able to move forward. We have to find an easier way to get this information available to potential franchisees. So I think your point is very, very well taken.

Mr. TIPTON. Chairman, I was just going to mention also, it was mentioned earlier about disclosure. Beyond—and in my experience with my franchisor, beyond all of the disclosure statements, we were encouraged to go talk to other franchisees all over, everywhere, all over the country. So I just wanted to mention that, too, that that was a big benefit in my start.

Chairman CARDIN. I think that is excellent advice. My experience is that, again, the successful franchise brands want that to take place. That is why they are successful. They want to make sure it is the right fit for the franchisee, and talking to other franchisees can be extremely helpful to know what you are getting into and make sure that is what you really want to do. So I think that is really good advice.

And I am going to agree with many of the panelists that a lot of this is just common sense type information we have got to get out there to make a decision. It may already be out there. It is just hard to find, and we need to facilitate.

One of the things I have learned about the SBA and where it is most valuable and the resource partners that work with small businesses is that the more mentoring, the more technical help, the more connections that can be made through the SBA services, the more successful a young business is going to be. So any connections that we can make in that regard, including connecting with other franchisees before a potential franchisee makes a decision, is going to be helpful. So I appreciate that advice.

Let me thank again all four of our witnesses. This has been extremely helpful. We will be following up, and we may be contacting you to help us as we go through this field.

The record will remain open for two weeks.

And with that, the Committee will stand adjourned, with our thanks.

[Whereupon, at 3:46 p.m., the Committee was adjourned.]

APPENDIX MATERIAL SUBMITTED



American Association of Franchisees & Dealers
The Center for Total Quality FranchisingSM

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 E-mail: rpurvin@aaafd.org
 Website: www.AAFD.org

The Honorable Catherine Cortez Masto
 United States Senate
 Washington, DC 20510

March 11, 2022

RE: Support of Franchise Legislation and Regulatory Efforts

Dear Senator Cortez Masto,

We are writing on behalf of the American Association of Franchisees and Dealers (AAFD) to thank you for your efforts to improve the franchise industry, and we pledge our support of your legislative and regulatory efforts.

AAFD is the oldest and largest national not for profit trade association advocating the rights and interests of franchisees and independent dealer networks. The AAFD supports more than 40 independent franchisee associations and trademark specific chapters, representing thousands of franchisee operated business outlets. Since our establishment in 1992, the AAFD has focused on its mission to define, identify and promote collaborative franchise cultures that respect the legitimate interests of both franchisors and franchisees, cultures we describe as embracing our vision of *Total Quality FranchisingSM*. The AAFD came into existence in response to a franchising community that has been evolving towards increasingly one-sided and controlling franchise agreements and cultures whereby franchisee equity and business ownership has been continually eroding such that many modern franchise systems have lost all vestiges of business ownership.

First, we would like to acknowledge your report released in April 2021, *Strategies to Improve the Franchise Model: Preventing Unfair and Deceptive Franchise Practices*. This report discussed many of the problematic areas in franchising. Next, we want to support S.1120, the *Small Business Administration (SBA) Franchise Loan Transparency Act of 2021*. The SBA sets its rates and fees to be self-funding, and poor SBA oversight of the franchise portfolio results in higher rates for all borrowers. The viable, successful brands pay for the bad actors. We also support S.2162, the *SBA Franchise Loan Default Disclosure Act*. This is simple transparency of taxpayer guaranteed loans; transparency that is needed

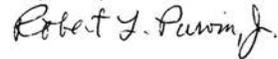
The Center for Total Quality FranchisingSM

for prospective franchise buyers. The free market only succeeds when the proper information is available to make market comparisons, this bill would provide that important information.

Finally, we want to thank you for your recent letter to the SBA asking for answers on problematic brands, like Burgerim, which has a franchisee chapter as a member of the AAFFD. It's time regulatory agencies and the SBA, along with the franchisors, take some responsibility for franchise failures. It's just not fair for franchisees to always bear the burden.

We look forward to working with you, to advance efforts to protect franchise owners and improve the franchise industry so that all can realize the success that franchising promises.

Respectfully submitted,



Robert L. Purvin, Jr.
Chair, Board of Trustees
American Association of Franchisees and Dealers



Keith R. Miller
Director of Public Policy and Engagement, American Association of Franchisees and Dealers
Principal, Franchisee Advocacy Consulting



The Honorable Ben Cardin
Chairman
Small Business Committee
U.S. Senate
Washington, DC 20510

The Honorable Rand Paul
Ranking Member
Small Business Committee
U.S. Senate
Washington, DC 20510

March 14, 2022

Dear Chairman Cardin and Ranking Member Paul,

On behalf of the American Hotel and Lodging Association (AHLA), I would like to thank you for holding the hearing entitled "Small Business Franchising: An Overview of the Industry, SBA's Role, and Legislative Proposals," to highlight the critical importance of the franchise business model on America's small businesses and the national economy.

AHLA represents all segments of the American lodging industry, including iconic global brands, hotel owners and franchisees, REITs, management companies, independent properties, bed and breakfasts, state hotel associations, and industry suppliers.

The topic of this hearing is particularly important to the lodging industry as over 90% of all hotels in the United States are franchised properties, with a majority owned by small business owners. The hotel sector is also a proud majority minority-owned industry, as more than half of the hotels in the United States are minority-owned. The hotel franchise model has paved the way for small business ownership for tens of thousands of immigrants, women, and people of color to achieve the American dream.

The hotel franchise model has long been a pathway for entrepreneurship and a secure business investment. Over the last forty years, the industry has shifted from concentrated corporate ownership of hotel properties to a predominantly franchised industry comprised of tens of thousands of franchisees. As a result of this dynamic, hotel owners and brand companies have a unique business relationship. Owners own the assets, the real estate and the capital, while the franchisor licenses the brand name and national marketing and sales platforms. As franchisees, hoteliers have come to appreciate and rely on both the SBA 7(a) and 504 loan programs to help finance new businesses, real estate acquisitions, construction costs, and working capital. These loans have helped provide the foundation to grow operations at reasonable interest rates. Importantly, several hotel brands in particular, and the hotel industry at large continuously demonstrate low default rates for SBA loans and rank among the best businesses in that category. The reliability of the hotel industry provides a secure investment for hotel franchisees and steadfast stewardship of American tax dollars.

Thank you for your discussion on this important topic and your focus on financing for American small businesses. Over the last two years in particular, the emergency SBA programs provided critical lifelines to the lodging industry. As we now move from relief to recovery, the SBA will continue to play an important role to help ensure America's hotel industry can continue to grow, create good jobs, and invest in local communities.

Sincerely,

Chip Rogers
President and CEO
American Hotel and Lodging Association



The Honorable Catherine Cortez Masto
 U.S. Senate
 516 Hart Senate Office Building
 Washington, D.C. 20510

March 10, 2022

RE: Support of Franchise Legislation

Dear Sen Cortez Masto,

We are writing on behalf of the Asian American Hotel Owners Association (AAHOA) to thank you for your efforts to improve the franchise industry.

AAHOA represents more than 20,000 first- and second-generation Americans. Our members are small-business owners who own and operate 60% of the hotels nationwide, supporting 1.1 million quality jobs in hospitality. As franchisees, our members consistently contribute to the economy through job creation, tourism promotion, real estate development, and community investment – in fact, our members contribute 1.7% to the nation's GDP.

First, we pledge our support for your legislation. We would like to also acknowledge your report released in April 2021, *Strategies to Improve the Franchise Model: Preventing Unfair and Deceptive Franchise Practices*. This report discussed many of the key problematic areas in franchising. Next, we want to pledge our support for S.1120, the *Small Business Administration Franchise Loan Transparency Act of 2021*. While the lodging industry is excluded from the requirements, we believe increased transparency is helpful to all franchisees and small business owners. We, at times, believe we are disadvantaged by the current lending environment and would like to see meaningful changes to SBA programs. We also support S.2162, the *SBA Franchise Loan Default Disclosure Act*. This is simple transparency of taxpayer-guaranteed loans – transparency that is needed for prospective franchise buyers. The free market only succeeds when the proper information is available to make market comparisons and sound business decisions. This bill would provide that important context.

Finally, we want to thank you for your recent letter to the SBA asking for additional accountability. This additional, necessary accountability will help level the playing field for hospitality franchisees as we recover from the extreme effects COVID-19 has had on our industry.

We look forward to continuing to work with you to improve the franchise industry so we all can realize the American Dream.

Sincerely,

A handwritten signature in black ink that reads "Vinay Patel" with a stylized flourish at the end.

Vinay Patel
 AAHOA Chair

A handwritten signature in black ink that reads "Nimesh Gandhi" with a stylized flourish at the end.

Nimesh Gandhi
 AAHOA Ambassador - Nevada

<http://www.bloomberg.com/news/articles/2015-05-14/franchise-loans-keep-blowing-up-and-the-government-keeps-backing-them>

Franchise Loans Keep Blowing Up, and the Government Keeps Backing Them

Nearly 20 percent get charged off by the SBA. Guess who pays

by [Patrick Clark](#) [Bloomberg](#) May 14, 2015

Buying a franchise is a risky business. Seventeen percent of franchise loans guaranteed by the U.S. Small Business Administration failed from 1991 to 2010, new data show. At the end of the period, almost one in five franchise owners went splat.

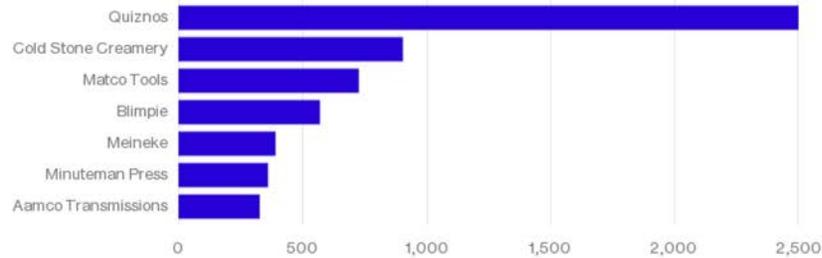
The loans, made by private lenders, weren't merely delinquent. Failed loans are those charged off by the SBA, which guarantees as much as 85 percent of the value of working-capital loans through its 7(a) program. Even after liquidating collateral, which can include franchise owners' homes, the government had to use taxpayer dollars to make the lenders whole.

Some franchises are worse bets than others. Meineke (22 percent), Quiznos (25 percent), and Huntington Learning Center (31 percent) had some of the highest failure rates among well-known brands.

So yes, running a business is harder than franchisors sometimes make it sound. Beyond that headline finding, the report is interesting for a couple of reasons.

Franchise Loans

Loans made to franchises with charges-off rates of greater than 20 percent, 1991-2010



Source: SEIU

Bloomberg 

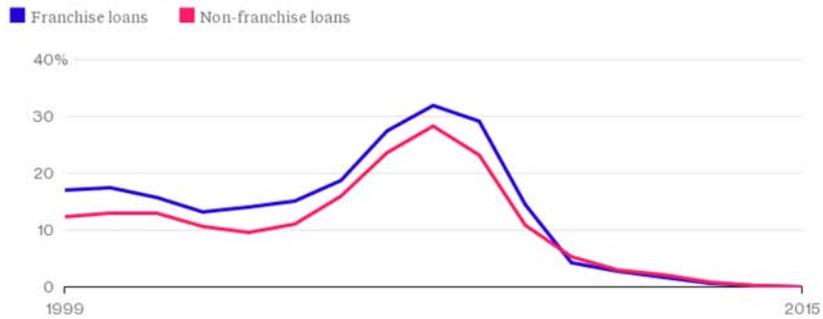
First, it was compiled by the Service Employees International Union, the labor group that's been fighting to raise pay for fast-food workers. That campaign would seem to put the SEIU in opposition to franchise owners, who are at least nominally responsible for setting wages. Increasingly, however, the union has been [aligning itself](#) with those franchisees, on the theory that corporate franchise systems wield a lot of influence over store owners' budgets.

"We believe the high failure rate is due to a severe imbalance of power between franchisees and franchisors that contributes to a system of too many unstable businesses and low-wage work in the franchised fast-food sector," says Tia Orr, senior legislative director of the SEIU California State Council.

The union ended its analysis in 2010 because newer loans have had less time to go bad, making them difficult to compare with older loans. It consolidated the findings into five-year periods to smooth out spikes in failure rates, which were particularly dramatic during the recent recession. Data provided to Bloomberg by the SBA show that working-capital loans to franchises haven't performed as well as loans to nonfranchise businesses:

Working Capital

Charge-off rates for the SBA's 7(a) loan program



Source: Small Business Administration

Bloomberg 

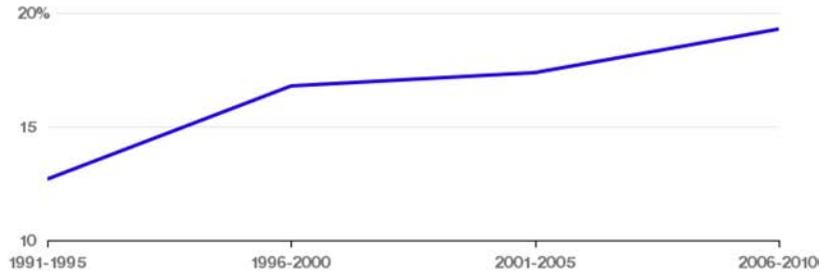
John Reynolds, president of the International Franchise Association Educational Foundation, says the union was “cherry-picking” data, and that the focus should be on the tens of thousands of franchisees who used SBA loans to successfully expand their businesses and add jobs to the U.S. economy. “I think [the SEIU] have an agenda that’s focused around casting doubt or criticism on the fundamentals of the franchise model,” he says.

Loan failure rates for individual franchise systems are hard to obtain, even though they could be useful to entrepreneurs deciding whether to invest in a franchise system. The union filed a Freedom of Information Act request to get its hands on the data. A recent paper co-authored by the SBA’s chief franchise counsel, Stephen Olear, said that “franchisors who do not provide financial performance representations to prospective franchisees but want to provide information to prospective lenders, or who wish to provide additional information to these lenders, are free to do so.”

When statistics do see the light of day, the numbers are [often scary](#).

Bad Bets

Failure rates for franchise loans backed by the Small Business Administration



Source: SEIU

Bloomberg 

Why does the government keep guaranteeing these loans? The agency has argued that banks tend to stop approving loans for struggling franchises and that franchise failure rates are similar to failure rates for the overall lending program.

Yet failing franchises often continue selling new units. Over the last five years, the bottom 25 percent of franchise systems have opened more than 42,000 new outlets, according to Jeff Lefler, chief executive officer of research firm FranchiseGrade.

“On one hand, franchisees aren’t doing enough due diligence,” Lefler says. “On the other, unhealthy systems are marketing themselves loudly and aggressively to franchisees.”

Correction: A previous version of this article mislabeled the first chart as representing the number of failed loans for the franchise chains listed. The chart properly represents the number of total loans issued for those chains, all of which had failure rates of greater than 20 percent.



March 15, 2022

The Honorable Catherine Cortez Masto
516 Hart Senate Office Building
Washington, D.C. 20510

RE: Support for the Franchisee Community

Dear Senator Cortez Masto,

On behalf of more than 46,000 franchisees nationwide who own over 122,000 businesses and employ over 2.7 million individuals, the Coalition of Franchisee Associations (CFA) is writing to thank you for your support of the franchisee community and ask that the Senate Small Business Committee follow your lead in protecting America’s small business owners.

By way of background, CFA is the voice of the franchisee – we are the largest franchisee-only trade association in the country. The CFA represents 23 franchisee associations whose members own brands including McDonalds, Burger King, 7-Eleven, Planet Fitness, Buffalo Wild Wings, Dunkin’ Donuts, Meineke, Supercuts, Dominos and Popeyes - among others.

First, thank you for your report released in April 2021, *Strategies to Improve the Franchise Model: Preventing Unfair and Deceptive Franchise Practices* which explains the imbalance of power in the franchise relationship and the need for oversight by the Federal Trade Commission. Further, we would like to thank you for introducing the *Small Business Administration Franchise Loan Transparency Act of 2021 (S.1120)* and the *SBA Franchise Loan Default Disclosure Act (S.2162)*. These bills increase the transparency in financial disclosures and provide more accurate information to prospective franchisees – the true stakeholders of the business.

CFA urges passage of this important legislation and asks for increased oversight of the imbalanced franchise relationship. While franchisors and banks continue to profit from misleading claims and resulting SBA loans, franchisees are the true victims, often risking their life savings to invest in their business.

Sincerely,

John Motta, CFA Chairman

Misty Chally, CFA Executive Director





FROM THE OFFICE OF SENATOR CORTEZ MASTO
STRATEGIES TO IMPROVE THE FRANCHISE MODEL:
PREVENTING UNFAIR AND DECEPTIVE FRANCHISE PRACTICES

APRIL 2021 | REPORT



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I. Executive Summary

In 2019, the Economic Policy Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs held a hearing on economic mobility and heard from a witness who described troubling practices affecting businesses operated as franchises.¹ This information was consistent with complaints Senator Cortez Masto had heard from press reports and constituents in Nevada. Following that hearing, the Senator, then-ranking Democrat on the Subcommittee in the 116th Congress, directed her personal office staff to analyze franchise business practices and explore any need for legislative and other reforms, leading to this report. This report suggests a menu of legislative, regulatory, and business reforms pursuant to Congress's jurisdiction over issues related to economic growth, employment, small business lending, and economic stabilization.

Nationwide, we hear stories of entrepreneurs who faced financial ruin because they purchased a franchise.² In the past decade, more than 4,000 Quiznos franchise locations closed, and the company declared bankruptcy.³ Dozens of entrepreneurs buying Huntington Learning Center franchises were provided false revenue estimates.⁴ The franchise owners, also known as franchisees, of Curves twice sued the company after being forced to make decisions that lost them revenue and threatened their viability.⁵ Burgerim franchisees allege the company sold 1,200 franchises in 39 states and DC with no viable business model.⁶

Difficulties facing the franchise industry should concern the nation: In February 2020, 8.67 million people are expected to work for as many as 785,316 franchises.⁷ Franchisees employ more people than those who work in construction and a roughly equal number to those employed in financial activities.⁸ Leaders in the franchise sector have dismissed or ignored aggressive sales practices and one-sided contracts that have damaged too many lives. The industry is too often measured by franchises sold; franchise corporations benefit from the sale of a franchise, but are not held accountable for franchise success or failure.

In response to the COVID-19 pandemic, sales of many restaurant franchise businesses continue to boom.⁹ Unemployed restaurant workers may decide to run their own business instead of looking for another job. Some franchise sales pitches recommend investors move their funds out of a volatile stock market and buy a franchise.¹⁰ Some franchise owners will receive suggestions to fund the new franchise using the Rollover for Business Startups (ROBS), putting their retirement funds at risk. As restaurants and other businesses close due to the economic collapse from the COVID-19 pandemic, some franchise brands, also known as franchisors, will be marketed at "a discount" to new investors.

However, some closed franchises are not shuttering solely due to the pandemic; a brand may have been troubled long before due to a franchise corporation's problematic and unfair practices.¹¹ In response to the pandemic, franchisors should work with their brand's franchisees to survive; some franchise corporations are allowing more flexibility in the franchise agreement – for example, reducing, abating, or deferring rents, royalties and marketing fees. However, some franchise corporations demand that franchise owners



agree to new contract terms to realize the benefits from those accommodations. For example, franchise owners, who may only be open fewer hours than required by their initial contract, report being forced to sign new contracts that are disadvantageous to them.¹² These new terms often release the franchise corporation from any legal liability.

There are good franchise corporations out there that provide profits to investors, living-wage jobs, and support for the community. But for too many and for too long, some franchise corporations and lenders have treated entrepreneurs unfairly, which cascades into low-wage employment and stores closing. Overly optimistic revenue projections are given outside the legal disclosure process; contracts are written by the franchisor and in the franchisor's favor; pre-dispute mandatory arbitration clauses block franchise owners' access to the courts; and contractual provisions allow franchisors to overcharge for licensing and marketing fees, demand kickbacks from vendors, or limit a franchise owner's right to free speech.¹³ These are the hallmarks of a franchise model that operates to strip small business owners of their wealth.

No small business is without risk, but franchises are marketed as safer investments because they are supposed to be proven business models.¹⁴ But when franchise corporations engage in deceptive practices or enforce unfair rules, such as demanding payments for inadequate training or requiring unfair contracts, while also using government resources and requirements to appear as a regulated investment or aid in financing, the government inadvertently condones franchises' misrepresentation.¹⁵ When franchise owners cannot financially survive, they struggle to pay their workers a living wage.

This paper details the problems reported by franchise owners of ten franchise brands – Burgerim, Complete Nutrition, Dickey's Barbecue Pit, Experimac, Subway, Quiznos, Curves, 7-Eleven, Huntington Learning Centers, and Massage Envy – although similar problems also affect additional franchises.

This report highlights four areas where franchise complaints are most problematic, including unfair and deceptive contracts that give nearly all control to the franchise corporation, a lack of honesty and transparency in the financial disclosure documents, costly kickbacks and overpriced goods, and fees charged for limited or no actual benefit.

This report recommends the following actions from Congress, agencies, state governments, and franchise corporations themselves:

- **Congress:** While federal agencies have the authority to protect franchise owners with existing rules, Congress can provide for a private right of action for franchise owners and require fair contracts. Congress can also increase funding for the Federal Trade Commission so it can enforce fair contracts and require the SBA to mandate the timely disclosure of financial performance information by franchise brand for all SBA-guaranteed loans.
- **Federal Trade Commission (FTC):** The FTC should revise its Franchise Rule to provide more investor protection by recognizing that voluntary financial



performance disclosure has failed to provide accurate information to investors. The FTC should prohibit franchise contracts that require pre-dispute mandatory arbitration. Contracts should not include non-disparagement and non-disclosure requirements; they prevent franchise owners from being honest with future investors doing their due diligence. The FTC should take enforcement action against duplicitous or unfair franchise corporations and seek penalties.

- **Small Business Administration (SBA):** Prior to providing a government guarantee of a loan to a franchise, the SBA should require franchise companies to provide actual historic revenue data and store closing information to franchise owners who are liable to repay the loan. The SBA should publish loan performance information by franchise brand and refuse to guarantee any loan to a franchise if the underlying franchise agreement includes terms such as mandatory arbitration, non-disparagement and non-disclosure clauses, or prohibitions against associations. Franchise brands with high levels of default should lose access to government-guaranteed loans.
- **State Governments:** California, Washington, and Minnesota have some of the strongest state statutes regulating franchise businesses. States should enact legal protections for franchise investors and owners and provide resources for enforcement of fair practices.
- **Franchise Sector:** The franchise sector and its trade association must set standards for franchise brands that require fair treatment for franchise owners. Business development agents and consultants should be required to register, receive annual education and have a fiduciary duty to the franchisee clients. They should also establish and provide assistance when a franchise mistreats its franchise owners.

The franchise industry needs to ensure that franchise owners are sold viable businesses with fair contract provisions, with a reasonable expectation of success. Federal and state governments must address this massive part of our economy; they must enforce their regulations against unfair, abusive and deceptive trade

practices and, where current rules and laws that prohibit unfair and deceptive practices fall short, they must strengthen them. Without adequate investor disclosure, some entrepreneurs may invest in a franchise brand that will strip their wealth, leaving them facing eviction, foreclosure, and bankruptcy.¹⁰ These franchise owners will be unable to

The franchise industry is large, and, over time has allowed many to realize their American Dream. There are many examples of great brands that have provided these opportunities...[H]owever, because of little transparency and oversight, it is also an industry with far too many examples of predatory franchise companies that take advantage of prospective entrepreneurs and leave them overworked, despondent and broke. We hear the lure of the industry as it advertises to be your own boss, with proven business models, and no experience necessary.

Keith Miller, Subway Owner.



experience the goal they had for themselves – a financially self-reliant business that provides services and good jobs in their communities. This report provides a road map to improving the franchise model which will serve our nation’s entrepreneurs, workers and communities.

II. Overview of the Franchise Sector

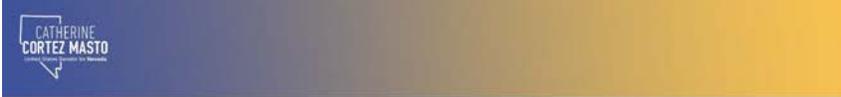
Franchise businesses provide business ownership opportunities to hundreds of thousands of entrepreneurs. The business model involves an owner licensing trademarks, methods, and other products to an independent entrepreneur. Franchise businesses provide a variety of services to people and communities, including restaurants, hotels, technical services, senior care, healthcare, and recreational activities.¹⁷

Typically, an investor (the franchise owner or the franchisee) pays a fee and in turn receives a format or system developed by the company (the franchisor). The franchise owner will often be expected to pay to the franchisor a percentage of their sales; royalty and advertising fees; and other associated costs for a small business, such as renting a location, paying fees to construct and equip the store, purchasing operating licenses, buying insurance, and stocking inventory. The franchisor can assist the franchise owner with finding a location, training materials for franchisees and employees, providing operational systems (such as establishing a point-of-sale system), receiving management assistance, offering marketing and a website, providing workshops and seminars, and setting up a telephone number or website for promotions, questions or concerns.¹⁸

Franchise owners come from all walks of life. One in seven franchises is owned by veterans, who are frequently encouraged to buy franchises through Transition Assistance Programs offered to service members separating from the service or through veteran franchise sales programs.¹⁹ About 30 percent of franchises are owned by Black Americans, Latinos, or Asian Pacific Americans.²⁰ Many immigrants choose to invest in franchises because of the perceived reliability of the brand backing the individual store.²¹

Franchises contribute millions of dollars to state and local economies. The trade association for franchise corporations and some franchise owners, the International Franchise Association (IFA), estimates that in February 2020, 8.67 million people are expected to work for as many as 785,316 franchises.²² Franchises employ more people than those who work in construction and a roughly equal number to those employed in financial activities.²³ About one-third of franchise businesses offer fast food;²⁴ on any given day, an estimated one-third of all American adults purchases food at a fast-food restaurant, many of which are franchises.²⁵

Franchise corporations promise business owners the dream of opening their very own small business. Some franchises market to people without experience, promising that the “will to succeed” is adequate as long as the franchise owner follows the rules laid out by the brand.²⁶



While franchises can be a prosperous and successful endeavor, some franchise companies are more interested in selling franchises than enabling franchise owners' long-term success.²⁷ The Office of Senator Catherine Cortez Masto received dozens of complaints from franchise owners – both from Nevada and across the country – about franchise contracts and unscrupulous franchisor practices that make owning a franchise a financially devastating decision. Franchise owners report receiving inaccurate information about profitability prior to investing in a franchise, being forced to buy overpriced goods and services, and having to comply with constantly changing and expensive requirements.²⁸ Sometimes, regional supervisors find fault with a store's management and operation so that the supervisor can report the store for noncompliance.²⁹ Overly aggressive or unfair compliance reporting can allow the regional supervisor to buy noncompliant stores at a discount rate, thus providing new fees from sales.³⁰ In Marcia Chatelain's 2020 book, *Franchise: The Golden Arches in Black America*, she states, "the relationship between franchisor and franchisee is like a distorted parent and child bond, in which the parent sets the rules and the child pays all the household bills...franchisees can make good money, but the franchising system requires skill at navigating an unequal power relationship."³¹

Franchises are sold as a proven – and profitable – business model. But when the actual numbers are revealed, what looks like growth may just be a lot of openings without consideration of store closures.³² From 2010 to 2018, franchise owners opened 353,685 outlets, yet the total number of franchises only grew by 78,878, an increase of only 20%.³³ Franchise corporations may blame the franchise owners for store failures, citing poor management or an inferior location, but the franchise owners are not necessarily at fault. Franchise store failure in the first year or two may be due to an unsustainable business model with poor unit economics, insufficient support or inadequate working capital to survive the startup growth period. A previously successful franchise may fail because of franchisor demands or encroachment from new, competing outlets into a territory.³⁴

Chart 1: Net Growth in the Franchise Industry Is Small³⁵





The franchise industry also tends to gauge success by whether a franchise outlet remains open. However, this measure of success may not account for profits gained from fees generated by a single store cycling through numerous owners in a short period of time. Franchise owners and regulators should be concerned about “churn” or “disorderly attrition” in certain brands; high levels of transfers, terminations, acquisitions by the franchisor, and ceased operations can be signs of an unsustainable business model that could have been financially unsustainable for previous owners.

What Are the Risks in Franchise Ownership?

Franchises are not ordinary investments. If someone invests \$100,000 in a stock, the stock could fail, and the investor could lose the entire \$100,000. If an entrepreneur invests the same \$100,000 to buy a franchise, the franchise owner risks considerably more than the \$100,000.³⁶ Franchise contracts can last for decades and require continuous payments of royalties, marketing, and other fees, as well as a share of the profits. Franchise contracts most often require personal guarantees from the franchise owner. Contracts may demand the owner upgrade the store, purchase goods and services from a specific vendor, or sell new products. Many franchise owners borrow from a lender to pay for the initial franchise fee, store renovation, and start-up costs. Most times, those loans are obtained by a borrower’s personal guarantee to repay with the borrower’s personal assets – such as a home, savings, retirement accounts, or land – as collateral. Assets can also come from the immediate family of the borrower. When a franchise is not profitable, franchise owners and their co-investors can lose these assets.

In addition to the personal loss to the franchise owner, failing franchise owners cannot pay living wages.³⁷ When franchise owners run deficits, they may struggle to pay wages and payroll taxes. When franchise owners fail to fulfill wage and tax obligations, they can end up in trouble with the government. Some franchises have nearly no employees – the franchise owners and family members work non-stop to keep these businesses afloat.³⁸

III. Government Oversight of Franchises Is Inadequate

Most people, especially prospective franchise owners, believe franchises are heavily regulated. Franchise corporations encourage this belief by promoting the different ways governments regulate and support franchises. The Federal Trade Commission (FTC) is widely recognized as overseeing franchise businesses. The Small Business Administration (SBA) publishes a Franchise Registry and provides loan guarantees through the 7(a) and 504 loan programs. The Department of Veterans Affairs (VA) promotes the franchise model to service members through its Transition Assistance Program. In addition, nineteen states have some oversight over franchise corporations.³⁹ However, government oversight is quite weak, which leaves franchise owners vulnerable to unfair practices by some franchise corporations.



The Role of the Federal Trade Commission

The Federal Trade Commission (FTC) regulates presale disclosure of franchises through its Franchise Rule.⁴⁰ The Franchise Rule is meant to ensure that entrepreneurs have access to information that can help them decide whether to invest in a franchise. It also requires franchisors to furnish a Franchise Disclosure Document (FDD) that includes specified information about the franchisor, the franchise business, and the terms of the franchise agreement. The FDD is meant to provide a plethora of information on the company, including information about the business and its executives; any litigation and bankruptcy history; costs and restrictions with suppliers, territory, and customers; advertising and training programs; financial performance; and financial statements.⁴¹ The Rule also prohibits franchisor misrepresentation.

The FTC is also responsible for investigating unfair, deceptive or abusive practices by franchises, and educating business owners about their respective responsibilities. This authority goes beyond the Franchise Rule; the FTC can prosecute franchise corporations engaged in unfair or deceptive conduct throughout the course of a franchise relationship. The FTC has not taken an enforcement action on a franchise matter since 2007.⁴²

In his Congressional testimony, franchise owner and advocate Keith Miller said, "on the first page of all FDDs, it specifically states in bold print, 'Note, however, that no governmental agency has verified the information contained in this document.'"⁴³ The FTC does not collect the FDDs; instead, it relies on potential franchise owners to do their own due diligence about the viability of the businesses with the information disclosed.⁴⁴

The FTC's approach relies on the franchise corporation disclosing accurate and complete information to the potential franchise owner who can choose whether to invest or not. A key element of disclosure is the financial performance representation made by the franchisor, yet this disclosure is voluntary. The FDDs should include break-even analysis, annual financial data and skills, knowledge and ability to run the business. In addition, financial performance representations should be presented in the same format by sector, such as hotels or restaurants. The FTC should also collect and post all FDDs so prospective investors can search by sector.

Even if information is disclosed, it may not be clear to a franchise investor reviewing hundreds of pages of a contract that the government does not approve – or even regulate – the investment.⁴⁵ Contracts can deny franchise owners the right to buy goods from a lower-cost source, prohibit franchise owners from organizing into an association, and even ban them from sharing their experience with current and future franchise owners. Some franchises refuse to provide the FDD until the potential owner pays an application fee, which generates additional profits for the franchisor. Some FDDs include disclaimers that protect franchisors from future allegations of unfair treatment. The FTC does little to take action against franchise corporations that provide inaccurate information or demonstrate deceptive practices. The FTC has taken no action to stop franchisors from providing inaccurate financial information outside of the FDD, either through third-party brokers and consultants or directly to the investor.



Not only is there no private right of action in the Franchise Rule which would enable franchise owners to sue franchise corporations, but the FTC permits contracts that require mandatory arbitration, prohibit disclosure and disparagement, and include language that allows the franchisor to change the terms of the contract without agreement from the franchisees. Additionally, franchise owners rarely have the cash to hire an attorney after putting all their resources into opening and operating the business. Since franchisors have deeper pockets, they can choose to extend litigation beyond what some franchisees can afford. Some franchise owners argue that the Franchise Rule is rigged in favor of the franchise corporations and against the franchisees.

The Federal Trade Commission's Franchise Rule

The current Franchise Rule requires franchisors to provide prospective franchise owners with their FDD at least 14 calendar days before franchisees make any payment or sign a binding agreement in connection with a proposed franchise sale. The FDD provides prospective franchise purchasers with 23 items of information pertinent to their investment decisions.⁴⁶ In practice, the Franchise Rule gives franchise owners the false belief that the FTC "approves" franchises and endorses them as viable investments. The franchise representative or a sales representative "may tell a prospective franchise directly and through subtle means that the FDD has been reviewed and approved by the government and it's a safe investment."⁴⁷ FTC's regulation of FDDs contribute to this problem. For example, the FTC allows – but does not require – franchisors to include financial information in Item 19 of the FDD. Franchisors are also permitted to include in Item 19 a disclaimer to the effect that any other financial information provided outside Item 19 is illegal and should not be relied upon as factual.⁴⁸ In practice, this is a problematic provision; it allows franchisors to connect investors with buyer development agents or brokers, franchise owners, newsletters, or other projections or data without the requirement of accuracy as franchise investors do not understand that financial material provided outside the FDD may not be reliable.

The FTC has rarely taken action against a franchise corporation for any reason, including deceptive financial documents. The FTC will argue that few complaints are filed, which until recently was true, in part because it is technically difficult to figure out how to file a complaint to the FTC. In addition, franchise owners who file complaints may face retaliation from the franchise company.⁴⁹ A common practice is for a franchise corporation to release a franchise owner with a failing business from the contract while prohibiting the franchise owner from making any disparaging comments or sharing complaints. These non-disclosure agreements in exchange for absolution of the remaining contract can lead to a cycle of failed franchise loans even though the FTC has stated that requiring consumers sign gag clauses is an unfair practice.⁵⁰ In addition, the FTC has traditionally preferred cases with many complaints, such as when 10,000 customers are overcharged \$20 on a transaction, instead of a few dozen or a hundred entrepreneurs who may have been misled into investing \$500,000 in a failed franchise. The FTC should not wait for franchise owners to file complaints; it can also consider evidence of problems noted by the Office of Inspector General's office at the Small Business Administration.



The Federal Trade Commission's Comment Periods on the Franchise Rule

In May 2019 and September 2020, the FTC solicited comments regarding the Franchise Rule.⁵¹ The FTC asked whether prospective franchise owners have benefitted from the Rule, what the costs of compliance are, and whether the Rule should be amended, especially to account for technological or economic changes. The Franchise Rule was last updated in 2007. In 2019, the FTC received 46 comments. Commenters representing the franchise owners generally wanted a more robust Rule that included financial performance representations, including "break-even" data and increased transparency around costs. Commenters representing franchisors argued the Rule should not be changed. In the Fall of 2020, the FTC sought additional comments on the Franchise Rule; by the December 17, 2020 deadline 239 comments were submitted, the vast majority from franchise owners requesting protection from franchise practices related to the FDDs and other practices which they allege are unfair.⁵²

The Role of the Small Business Administration

Prospective franchise owners can receive guaranteed loans from the Small Business Administration (SBA) through the 7(a) or 504 loan programs.⁵³ The SBA maintains a Directory of all franchise brands that meet the SBA's criteria. Only franchise brands listed in the Directory, which is managed by an outside vendor, may receive SBA-guaranteed loans. Eligible franchise brands must meet the SBA's affiliation rules regarding ownership, management, license, and other eligibility criteria.⁵⁴ For example, 7-Eleven franchise owners are not eligible for SBA-guaranteed financing as their corporate office retains significant control over day-to-day operations. For some franchise owners, seeing a brand listed in the Franchise Directory provides a sense of legitimacy, which can lead to undue belief in the viability of the brand.

SBA-affiliated lenders (SBA-AL) determine if the brand and a loan applicant are creditworthy and low risk. According to SBA's Standard Operating procedure, the franchise owner must be able to repay the loan through profits from the business, not from the owner's personal wealth. SBA's Office of Credit Risk Management is responsible for analyzing the loan portfolio and reviewing lender performance. However, the SBA-AL is the entity responsible for identifying and avoiding poorly performing loans and avoiding fraud.⁵⁵

There is a lack of clear data reporting on the performance of SBA loan guarantees provided to SBA-ALs for various franchise brands. The data and charts in the following pages are provided by public sources, supplied by the SBA, or based on research by Senator Cortez Masto's office from publicly-available SBA data. The Senator's staff requested technical comments from the SBA staff to confirm or correct the analysis, but the SBA staff declined, citing their practice of "not publicly releasing information that could be competitively harmful to both franchisors and franchisees."⁵⁶ SBA staff wrote in an email that, "since the charts and graphs are limited to the Agency's experience with franchise loans they may not portray an accurate picture of the Franchise Groups' overall default and charge-off rate or financial health."⁵⁷ This report provides this data to better inform readers of the large number and large financing amounts of SBA guaranteed loans to

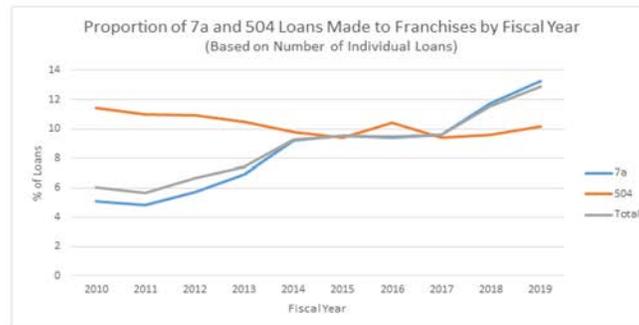


franchises and the high levels of default with SBA loans to some franchise brands. All of these figures are prior to the COVID-19 pandemic.

According to the data from the Small Business Administration – and as shown in Chart 2 – franchise loans make up 13% of the SBA’s total loan portfolio.⁵⁸ Lending to franchises has increased over time; SBA-guaranteed loans to franchises have increased more than 20% in number of total loans and in amounts guaranteed since 2017. Loans to franchises are made through two SBA programs:

- **7(a).** In 2019, SBA’s 7(a) program guaranteed 51,907 business loans, of which 6,874 loans went to franchise businesses; franchise businesses received 13% of the total loans. The 7(a) program guaranteed \$17 billion in loans, of which franchise loans were \$3.7 billion (22% of funds guaranteed).⁵⁹
- **504.** In 2019, SBA’s 504 program guaranteed 6,099 business loans, of which 621 loans were to franchise businesses, approximately 10% of the loans. The 504 program guaranteed loans worth nearly \$5 billion, of which franchise loans make up \$851 million (17% of funds guaranteed).⁶⁰

Chart 2: Proportion of 7(a) and 504 Loans Made to Franchises by Fiscal Year⁶¹



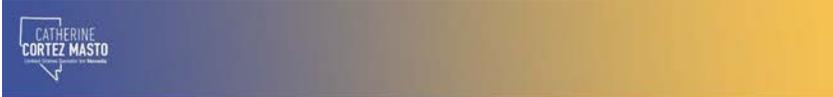
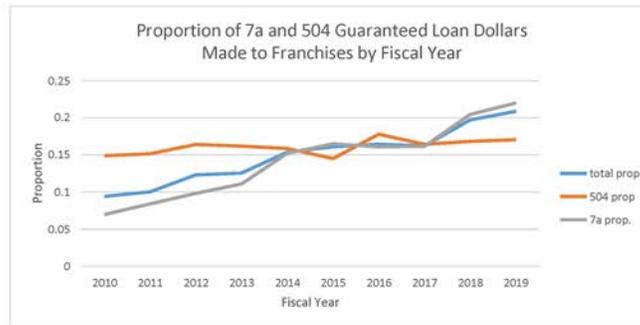


Chart 3: Proportion of 7(a) and 504 Guaranteed Loan Funds Made to Franchises by Fiscal Year⁶²



For decades, advocates and some franchise owners asserted that poor oversight of the SBA loan guarantee programs enabled failure and deceptive practices.⁶³ From 2003 to 2012, more than one in four loans – 28% – to franchises guaranteed by the 7(a) program defaulted,⁶⁴ which required that the SBA compensate lenders with \$1.5 billion for failed loans.⁶⁵ Failed loans occur after the lender liquidates collateral, seizing the borrower’s assets, home, land, and retirement accounts.⁶⁶ Charts 4 and 5 are *Bloomberg* and *Wall Street Journal* analyses finding high failure rates for well-known franchise brands.⁶⁷



Chart 4: Some Franchise Brands Experience High Defaults. 1991-2010 (Bloomberg Analysis)⁶⁸

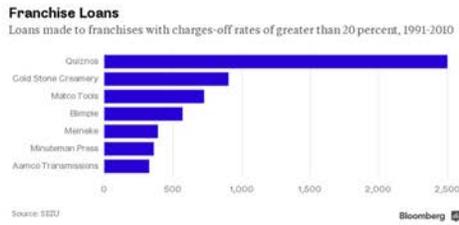


Chart 5: Top Franchise Defaulters Fiscal Years 2004-2013 (Wall Street Journal Analysis)⁶⁹



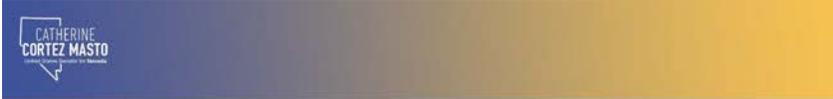


Chart 6: Loans Issued to Selected Franchises (Cortez Masto Staff Analysis, February 2020)⁷⁰

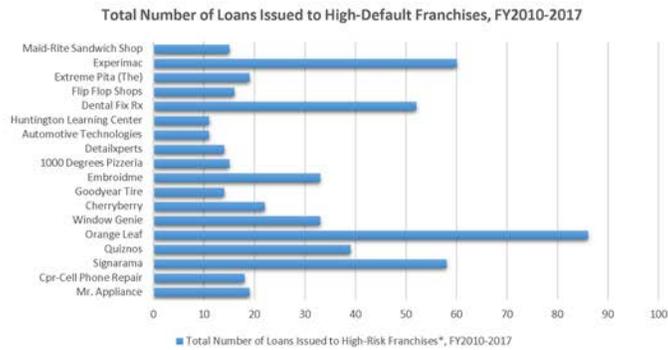
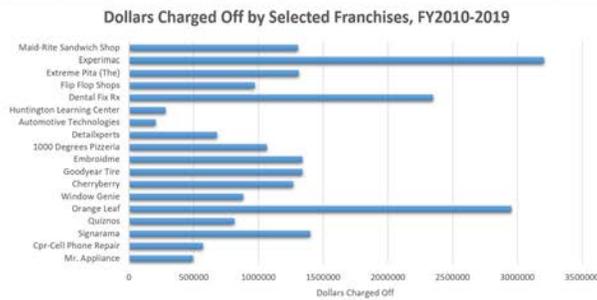


Chart 7: Dollars Charged off by Selected Franchises (Cortez Masto Staff Analysis)⁷¹



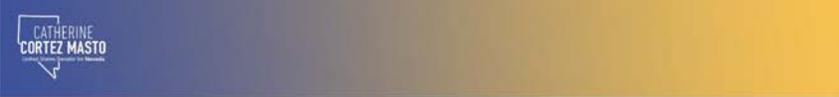


Chart 8: Charge-off Rates of Selected Franchises (Cortez Masto Staff Analysis)

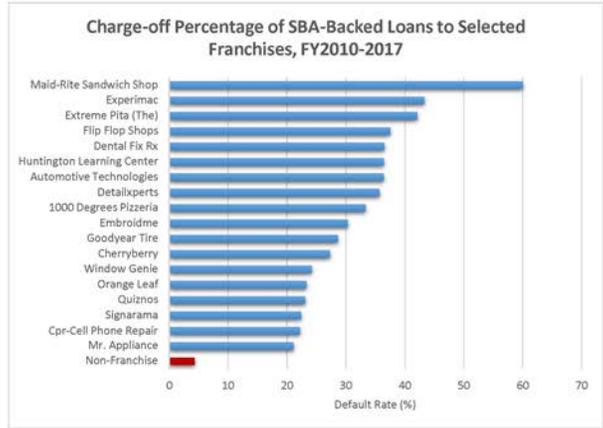




Chart 9: Data on SBA Loans to Selected Franchises – FY 2000-2020 (Cortez Masto Staff Analysis, February 2021)

Source: Analysis of SBA Loan Data made public by the FOIA (<https://www.sba.gov/about-sba/open-government/foia#section-header-32>)

Franchise	Loans Guaranteed	Loans Charged Off	% Charged Off	Amount Guaranteed (millions of dollars)	Amount charged off (millions of dollars)	% Charged Off
Complete Nutrition	63	9	14%	\$5.22	\$3	57%
Dickey's Barbecue Pit	269	55	20%	\$45.91	\$14.99	32%
Experimac/Experimax*	74	35	47%	\$7.47	\$4.94	66%
Quiznos	2133	637	30%	\$248.01	\$64.47	26%
Curves	409	82	20%	\$29.88	\$9.79	33%
Huntington Learning Center	177	64	36%	\$26.96	\$12.10	45%
Meineke	356	102	28%	\$65.24	\$20.93	32%

*Experimac does not pre-date 2016

The Small Business Administration Received Decades of Warnings

For decades, the SBA's Office of Inspector General (SBA OIG), the Government Accounting Office (GAO), and independent researchers published reports raising concerns about SBA guarantees of loans to poorly performing franchise owners. Below are some notable reports:

- The SBA OIG noted difficulties with franchise lending in its *Report on the Most Serious Management and Performance Challenges Facing the Small Business Administration in Fiscal Year 2020*.⁷³ The SBA OIG wrote, "SBA continued to guarantee loans to high-risk franchises and industries without monitoring risks, and where necessary, implementing controls to mitigate those risks."⁷³ It also identified lender noncompliance, and found that lenders had failed to provide documentation to support requirements that borrowers had met requirements related to eligibility, repayment ability, size standards, franchise agreements, business valuations, appraisals, equity injection, and debt refinance.⁷⁴
- In 2013, the Government Accountability Office released a report (GAO-13-759) that showed during the previous 10 years, "SBA guaranteed franchise loans under its 7(a) program totaling around \$10.6 billion. SBA made guaranteed payments on



approximately 28 percent of these franchise loans, representing about \$1.5 billion.⁶⁵ Lenders receive government payment after the borrower's collateral is seized. Four lenders originated most of the failing loans. The GAO report found that, over a dozen years, more than 40% of buyers of a single franchise defaulted on the loans that the SBA guaranteed, costing \$11 million in guarantees.⁶⁶

- A 2013 SBA OIG report reviewed loans for the franchises Planet Beach, Petland, and Cold Stone Creamery and found default rates above 46%, resulting in \$39 million in guarantees paid.⁶⁷
- In 2011, the SBA OIG published a report finding inflated gross revenue projections in loans made to Huntington Learning Center franchise owners.⁶⁸ The OIG found that the lender used inflated numbers to get the SBA guarantee for the bank. The OIG recommended the SBA seek recovery of the loan guarantees, less any recoveries, paid in connection with the 10 defaulted loans that cost the SBA more than \$2 million.⁶⁹
- A 2013 GAO report found borrowers in the Patriot Express program, an SBA program meant to facilitate loans to veteran-owned businesses, had high failure rates.⁷⁰ Defaults cost \$31 million in total, with a default rate consistently exceeding other SBA programs.⁸¹ Default rates were so high that SBA did not renew the program when it expired in December 2013.

IV. Case Studies

This section considers franchise models that work for franchise owners as well as those that are problematic.⁸²

Franchise Models That Work

The restaurant industry is generally riskier than others. When operated from the top with the franchisee's best interest in mind, the franchise model can successfully mitigate that risk for a small business owner. Popeye's is a positive example of how a franchising corporation can be successful both for the franchisees and for the shareholders. In 2007, the company had a leadership change following a series of struggles. The former CEO, Cheryl Bachelder, brought a values overhaul to the company.⁸³ Her methods focused on putting the franchisees' interests first and including them in discussions regarding advertising and fees. The company's corporate management tracked restaurant-level productivity closely, and bottom-up growth followed. A *Harvard Business Review* article reports a growth in revenues from \$154 million to \$259 million in the four years from 2011 to 2015.⁸⁴ That growth included an increase from \$24 to \$44 million in net profits to the corporation, while the rest of the growth went to franchisees.⁸⁵ Evidence for Popeye's recent success can be found in the results of the 7(a) and 504 loans the company's franchisees have received. Since Fiscal Year 2010, Popeye's franchisees have received seventy 7(a) loans and forty 504 loans. As of the end of the 2019 fiscal year, sixty loans had been paid back in full, and zero have defaulted.⁸⁶



Dunkin' is another example of a business model that successfully mitigates the franchisee's risk. Dunkin's franchisees have received 147 SBA-backed loans since Fiscal Year 2010, and not one has defaulted.⁸⁷ *Entrepreneur* ranked the company number one on its 2020 Franchise 500 list, a spot it earned based on its national brand name recognition, effective marketing, high expected earnings, reasonable fees, and the wide array of support offered by the franchisor.⁸⁸ The company has demonstrated remarkably fast growth over the past ten years and, unlike other franchises, all of its locations are owned by franchisees.⁸⁹

Outside of the restaurant business, FASTSIGNS has gained a notable reputation as a supportive and highly successful franchisor. Of the 167 SBA loans its franchisees have received since Fiscal Year 2010, only one has defaulted; 35 have been paid back in full.⁹⁰ In fact, *Franchise Business Review* has listed FASTSIGNS as a top 200 franchise every year since 2006.⁹¹ In addition, *Entrepreneur* ranks FASTSIGNS number one in the world in its category and 55th overall.⁹² FASTSIGNS' success is partially because the company allows individual owners to make decisions about their own business. For example, franchisees have the freedom to set their businesses' hours, and they face very low minimum staffing and inventory requirements.⁹³ FASTSIGNS CEO, Catherine Monson, is well known for measuring the importance of franchisee profitability as the long-term key to growth in the company.

Franchise Models with a History of Owner Complaints

Burgerim

Burgerim is a fast casual restaurant that has grown quickly in a few years, from only one franchised location in 2016 to at least 1,550 licenses sold by the end of 2019.⁹⁴ Over that period, Burgerim raised at least \$57.7 million in franchise fees.⁹⁵ Yet, as reported in *Restaurant Business*, many Burgerim franchisees are already facing financial ruin.⁹⁶ In 2019, Burgerim announced that it was considering bankruptcy and had hired a new CEO, a chief restructuring officer, and a bankruptcy lawyer. The founding CEO fled the country.⁹⁷

The Maryland Attorney General and Securities Commissioner issued a Stop Order against Burgerim and suspended franchise registration in Maryland on the grounds that the FDD failed to disclose the company was going through bankruptcy.⁹⁸ Within a month, the state of Washington also revoked Burgerim's right to sell franchises.⁹⁹ The company's franchise registrations expired in Virginia and Maryland and were not renewed.¹⁰⁰ In February 2021, the state of California fined Burgerim executives nearly \$4 million dollars for concealing the number of cancellations and refunds, mismanaging franchisees' initial franchise fees, bouncing refund checks, and abandoning its franchise obligations.¹⁰¹ The SBA guaranteed \$38 million loans to 119 Burgerim franchise owners.¹⁰²

Jay Hackstaff, Reno, Nevada: *"I've been in the restaurant business for 21 years. I've never seen a business so unorganized...what you are seeing in the news, it's 1,000 times worse. There are all these things Burgerim is supposed to do that are clearly stated in the franchise agreement but they are not doing them."*¹⁰³



Complete Nutrition

In March 2019, Complete Nutrition, a franchise that provides nutrition and health supplements and other related products, told its franchise owners it would no longer provide any franchise services.¹⁰⁵ Individual stores had the option to become independent, but they were required to pay as much as \$10,000 to do so. Alternatively, the stores could remain part of the franchise and follow all previous franchisee requirements, including paying monthly royalties based on gross sales, and meeting certain higher sales quotas of specific Complete Nutrition products while competing with Complete Nutrition Corporate's online sales.¹⁰⁵

Prior to that decision, Complete Nutrition had made major changes to its franchise model that franchise owners said were harmful.¹⁰⁶ According to the franchise owners, Complete Nutrition lowered pricing across all products, which reduced franchisees' profit margins by 30%.¹⁰⁷ The franchise also required franchise owners to pay high fees if they did not make impossible targets, such as selling certain types of products that were not readily available. Through the shared point-of-sale system, Complete Nutrition obtained email contact information for the customers of its franchise owners and began marketing to all customers, sending them special discount offers coupled with free mail delivery. Stores were unable to compete with Complete Nutrition's online business, because the online offers were lower than what the franchise owners paid wholesale and thus price matching would cause franchise owners to lose money. In the end, these promotions reduced income to the franchise owners who operated the store locations.

In April 2019, Complete Nutrition franchise owners allege, the corporation eliminated franchise owners' access to the point-of-sale system, removed franchise owners' locations from its website, and sent an email to the customers telling them that their retail locations had been sold and that customers should order online. A few days later, Complete Nutrition sent an apology email to all the customers of its stores saying the email was sent in error, but damage to the franchised stores had been done.¹⁰⁸

According to data provided by the Small Business Administration, the agency guaranteed more than \$17 million in loans to 67 Complete Nutrition franchise owners. At least 12% percent of the loans have been charged off, which cost SBA \$574,657.¹⁰⁹ The most recent data from SBA on late payments (as of March 31, 2019) reports that 45% of Complete Nutrition loans are not current.¹¹⁰ And this was before they cut off franchise services.

Michael Hataway, Reno, Nevada: *"They canceled our membership loyalty program (replacing it with a FREE program) which was an average of \$3,500 per month in sales for my store, that's \$40,000 per year...I'm shutting my store down at the end of this month. It's just not worth the fight anymore and I've lost so much money".¹¹¹*



Dickey's Barbecue Pit

Restaurant Business reports that Dickey's Barbecue Pit franchises are closing at an alarming rate.¹¹² According to the Dickey's Barbecue Pit Franchise Disclosure Document (FDD) dated September 4, 2018, for the fiscal year ending May 31, 2018, the brand opened 72 new franchised units, but had 89 terminations and 24 ceased operations, for a net store loss of 41 units. An additional 44 units transferred to new owners.¹¹³ Dickey's ended the fiscal year with 521 units. In comparison, the previous fiscal year showed 88 units opened, 70 ceased operations, and 67 transferred.¹¹⁴ Dickey's store performance has only gotten worse; in fiscal years 2019 and 2020, Dickey's opened 60 and 30 stores respectively, but ended May 31, 2020 with only 466 units.¹¹⁵

Some franchise owners allege that some of the loan failures may be due to Dickey's Barbecue Pit leadership providing misleading and inaccurate information to potential franchise owners, resulting in failed businesses and bankruptcy.¹¹⁶ Some franchise owners allege that Dickey's Barbecue was telling franchise owners to expect revenue of up to \$80,000 per month, but most stores earned much less.¹¹⁷ In addition, new menu boards, errors with gift cards, and costly promotions decreased profitability for franchise owners. Franchise owners contend that Dickey's leadership lied about reasons that stores are available for sale.¹¹⁸

The 2019 Pit Owners' Association Franchisee Satisfaction Survey reported that 75% of current Dickey's franchise owners say the franchise agreement they signed is not fair, 85% said they would not invest in a Dickey's again, and 61% are considering closing their store.¹¹⁹ At the end of 2019, the SBA guaranteed 255 loans to Dickey's Barbecue franchise owners for more than \$72 million, of which 41 (nearly \$11 million) were charged off. The most recent data from SBA on late payments (as of March 31, 2019) finds that 28% of Dickey's Barbecue Pit loans are not current.¹²⁰

Amin Abdelkarim, Dickey's BBQ, Texas: *Amin is an immigrant from Egypt who worked double shifts at the Dallas Fort Worth International Airport and saved enough money to invest in a business. He purchased a Dickey's Barbecue Pit franchise. He was given the FDD, as well as a spreadsheet showing estimated startup costs, and was provided assistance with applying for an SBA 7(a) loan. He alleges that the estimates given were grossly incorrect, and all his startup capital was spent getting the business open. He opened his business in August 2018, but one month after opening, he had no money. He could not pay his SBA loan, and feared he would lose his home, rendering his family homeless. Dickey's reminded him of the 60-month liquidated damages clause in his contract. His other option was to sell his business to a buyer Dickey's found, for pennies on the dollar. Either way, he knew his SBA loan was going in default, and he was*

“In a few weeks, I will find myself, my disabled wife, and my 89-year old mother in law in the street, with no house, no car, and no money.”



going to lose all his assets. At one point he said, "In a few weeks, I will find myself, my disabled wife, and my 89-year old mother in law in the street, with no house, no car, and no money."¹²¹

Anonymous Dickey's BBQ owner, Southwest United States: "I feel Dickey's is using franchise owners and their money to sell direct to supermarkets and develop a software company. Their recent actions show no care for owners' income, just increasing the corporation's share of revenue by auto shipping and billing for products they know won't sell and also charging owners above retail price and receiving the rebates on owners' forced purchases. Dickey's has already placed product for sale direct to consumer in Walmarts across the country directly competing with the local restaurant and selling direct at less than what they charge owners."¹²²

Experimac/Experimax

Experimax sells and repairs previously used Apple brand computers, tablets, and phones. In response to a lawsuit from Apple, Experimax legally changed its name to Experimax due to a legal complaint with Apple that some franchise owners say was not disclosed.¹²³ A number of these franchise owners – including six who filed complaints with the Federal Trade Commission – state that the estimated revenue projections provided by Experimax specifically to obtain SBA loans were inflated and that they never earned the revenue reported as typical.¹²⁴ Some franchise owners say they were coached on how to "fudge numbers" to obtain an SBA guaranteed loan. They also contend they were not provided the training, services, and supply chain of quality goods promised and for which they paid. Experimax required unusually high initial payments of \$49,500 per franchise owner.¹²⁵ Experimax franchisees allege that the company also required franchise owners to spend \$130,000 to design the store and buy supplies at inflated prices.¹²⁶

Between January 2016 and December 2019, SBA guaranteed 80 loans to Experimax franchise owners. Most of the loans – 86% – were made by one bank. At the end of 2019, 26 of the 80 loans (33%) had been charged off. In addition, 8 loans were not current but not yet charged off.¹²⁷ Despite these high default rates, the franchisor was still falsely promising potential franchise owners that there were "locations in our Million Dollar Club".¹²⁸ Experimax's current FDD shows the highest volume franchised location with revenue of \$822,375, with an average unit doing \$410,639.¹²⁹

Jeff and Gina Siepierski, New York: "We have sacrificed our careers in order to invest into the Experimax/x brand. In addition, we have invested every cent of our \$103,000 savings of stocks, have taken on an additional \$90,000 in personal credit card debt, signed as personal guarantors to over \$300,000 in business. Now in year 5, when compared to the inflated projections provided to secure our SBA loan, our Experimax/x store has a (\$1,145,000) shortfall [30%] at the end of 2020 despite being one of the top 3 stores in the company."¹³⁰



Mark Shor, Henderson, Nevada: *He retired from his IT job at a New York State university and bought an Experimac franchise outside of Las Vegas in order to be closer to his brother. He was hopeful that it would be an enjoyable job for his retirement and allow his son to take over the business. "The franchisor directed me to a loan broker that helped me apply for and obtain an SBA 7(a) loan. The loan broker provided a projection spreadsheet that showed nearly \$700,000 in revenue for the first year, \$995,400 the second year," he said. Shor never earned anywhere close to such projected revenue. He plans to close his store soon. He and his son were the only employees, and they may end up defaulting on the loan greatly reducing the funds he set aside for his retirement.*¹³¹

Subway

Numerous journalists have reported that Subway sandwich shop franchise owners across the nation are struggling to survive, with what franchise owners say are heavily discounted promotional offers and corporate decisions that undermine the franchise owners' survival.¹³² Some franchise owners allege that franchisees have little say in the vendors that are chosen or the way prices of goods are set, nor can the franchise owner use its leased premises for another purpose.¹³³ Franchise owners have accused Subway of using minor infractions to "steal" the stores from franchisees through a rigged inspection and arbitration system.¹³⁴ Franchise owners also allege Subway allowed stores to open within blocks of existing locations or forced franchise owners to open additional stores nearby, a practice *Business Insider* referred to as "cannibalizing businesses."¹³⁵ More than 75 Subway franchise owners submitted comments to the FTC raising a variety of business practices they consider unfair, such as demand for renovations and new programs, costly rebates, and changes to the operations manual.¹³⁶

Subway franchise owners also allege that a Business Development Agent (BDA) in the western region misused his power to force and deny store sales.¹³⁷ Usually the BDA's duties include franchise sales, site location assistance, training, and operational assistance. However, as reported in the *New York Times* and in litigation, the BDA earns more money – a 2.5% increase in the franchisee's monthly fee – and can take non-performing stores for infractions such as choppy vegetables, "dirty mop sink", "card reader not fastened to the counter", being "out of product" when Subway controls product delivery, or other violations found by "hit men" inspectors.¹³⁸ One Nevada franchise owner alleges that such an inspector "sabotaged a bag of meatballs by puncturing the storage bag with a thermometer and then waiting until the temperature went up to record the temperature of the meatballs."¹³⁹ Others report similar "hit jobs" designed to report the franchise owner as non-compliant. Franchise owners report being forced into long arbitration processes where they are unable to win.

Over the years, the SBA has guaranteed loans to 1,669 Subway franchise owners worth \$417 million. Of those, 191 loans for more than \$16 million were charged off – at a cost of more than \$12 million to the SBA. In addition, 11% of SBA loans to Subway franchise owners have defaulted; 76 loans are not current but have not yet defaulted.¹⁴⁰



An anonymous Subway franchise owner for more than 20 years: *"The \$5 foot-long sandwich promotion which runs for three months out of the year for many years is a major financial burden for franchise owners. Recently Subway had a \$2 meatball and \$2 cold cut combo sandwich promotion where we lost huge amounts of money. Subway never reduced its royalty fees during these promotions. As Subway has made profit on this promotion, the franchise owner has to pay the burden all the costs and expenses like food cost, labor cost, etc. Subway has also saturated the market by coercing franchise owners to open Subway stores too close to other stores which destroys the business of existing stores. We have to spend money to remodel our stores. We have no way out. And when you complain, they use unethical business technique by putting your store out of compliance and force you to shut up."⁶⁴¹*

Vishal Sharma, former Subway owner in Reno, Nevada: *"I regret ever buying this Subway franchise. It was one of the worst decisions of my life. I had a successful store but the franchisor rigged the rules to force me out of business and I lost everything. I am still fighting this battle in court on my own, this has drained all my funds, but I am doing my best to fight this injustice."⁶⁴²*

Curves

Curves gym for women was a fast-growing franchise that had more than 10,000 locations in the U.S; today, as of April 30, 2020, only 284 remain in operation.¹⁴³ Franchisees went to court in two separate cases against new owners, who allegedly stripped wealth out of franchisees' businesses.¹⁴⁴ Franchise owners claimed that Curves misrepresented information relevant to their decision to enter franchise agreements and that the brand later violated those agreements. In 2017, a Texas jury returned a unanimous verdict in favor of 52 qualifying Curves franchise owners, awarding them 80% of their net operating losses, totaling approximately \$1.5 million.¹⁴⁵ Curves appealed the decision to the United States Court of Appeals for the Fifth Circuit. The parties ultimately settled while the case was on appeal.¹⁴⁶

In February of 2020, 32 former Curves franchise owners sued the investors who purchased the Curves company. The franchise owners alleged that a 2012 study by the investors' consultants reported an expected 15% failure rate; the study was not shared with the franchise owners.¹⁴⁷ Instead of making changes, the new owners sought to increase their profits by increasing royalties and selling products to franchise owners.

Megan Edwards, California: *"Less than 24 months after buying the Curves franchise, I was in financial ruin. All of this occurred as I struggled to successfully manage the franchise and meet never-ending corporate purchasing demands and haphazard rollouts. At no point were we ever able to show a legitimate profit that included a true owner draw or that wasn't used to reimburse money already 'spent out of pocket.' On August 31, 2014 the Club was shuttered, 2 1/2 years into the 5 year Franchise Agreement. The lack*



of honesty, transparency, respectful communication and misleading franchising agreements, devastated us and other franchise owners. My savings were depleted. I was forced to sell my house and I took out a title loan on my vehicle; and I'm in litigation with several creditors. I don't have the money to visit my 93-year-old mother in Canada."¹⁴⁸

7-Eleven

Franchise owners of this large convenience store chain have reported pressure to sign unfair agreements that allow the company to exert pervasive control over its owners both financially and operationally.¹⁴⁹ They say these contracts have taken away much of the control over day-to-day operations from franchise owners, including staff work assignments; owners give as much as a marginal rate of 59% of all gross profits directly to the corporation despite declining store gross profit. In 2018, 7-Eleven required a large number of franchise owners to sign new contracts as part of their renewal option. Franchisees report that this new contract was significantly different from the previous contract and included a \$50,000 franchise renewal fee, and required franchisees to pay 100% of liability insurance for property and equipment, even though that equipment was not owned by franchisees. The contract also included a more regressive profit-sharing model that franchisees allege heavily favors the corporation, one-sided legal fees, mandatory and often overpriced vendors, and mandated operation hours (including Christmas Day). Some owners say that closing during the night would actually be safer for their staff and the community, but they are not allowed to make that decision.¹⁵⁰

Gasoline pricing has been another point of contention. Franchisees say that retail gasoline prices are set by the corporation, and franchisees receive an exceedingly small fixed commission based on the number of gallons sold. Gasoline pricing is often set higher than the competition, which tends to reduce the number of gallons sold. Gasoline acts as a loss leader for franchisees and can fail to cover the cost of gas operations.¹⁵¹ The fresh food and hot foods that 7-Eleven offers also yield a lower net profit due to a high amount of waste when food expires before it can sell. Food items also add increased labor costs. Franchise owners allege that the financial impacts of these fixed prices for gas and fresh or hot foods are not disclosed in the FDD.¹⁵²

Press reports, including from the *New York Times* and *Bloomberg*, have also highlighted that 7-Eleven's franchise agreement allows the corporation to take back stores if franchise owners violate immigration law.¹⁵³ Some franchise owners believe that the company may have used Immigration and Customs Enforcement (ICE) to target specific franchisees and take away ownership of profitable stores, and as a result, they are suspicious of immigration officers issuing inspection notices and arresting undocumented immigrants at stores.¹⁵⁴ A significant majority of 7-Eleven franchisees are immigrants or minorities who invested their life's savings or borrowed money, often at high interest rates, in pursuit of the "American Dream." Many of these franchisees started with very little, they and their families often work long hours with little or no time off to build the business. At one time,



franchisees felt like the Independent Contractors the 7-Eleven agreement claims them to be, allowing them the latitude to make decisions to ensure their financial success, but many say that is no longer the case.

Furthermore, franchise owners contend that the corporation requires franchise owners to sign one-sided legal provisions in the event of legal disputes between the corporation and franchise owners. These provisions force franchisees to pay 7-Eleven's court fees even if they win, give up their right to a jury trial, and subject them to Texas' governing laws regardless of where they operate, depriving them of the benefits of their home state laws and court systems.¹⁵⁵

Anonymous, Southwest United States: *"We do not have the support we need to financially succeed. Investing in a 7-Eleven is not a good decision. [The company] does not get the lowest cost of goods from its vendor partners, nor does it have the franchisee's best interest at heart."*¹⁵⁶

Huntington Learning Centers

The Huntington Learning Center franchises provide scholastic tutoring. In 2011, an SBA Office of Inspector General report found that when Banco Popular originated Huntington Learning Centers (HLC) franchise loans, the bank did not adequately assess borrower repayment ability.¹⁵⁷ Instead, the lender approved the loans based on inflated gross revenue projections submitted by loan brokers in SBA loan applications.¹⁵⁸ According to one Connecticut franchise owner, HLC's loan consultant steered him towards Banco Popular and provided first-year revenue projections totaling just over \$500,000, which allowed him to receive a \$300,000 loan.¹⁵⁹ As the franchise owner's business started to fail, he wondered why he was so short of the projections he'd been given. He found other franchise owners opening at the same time were also far short of their projections. Then, he found out that actual first-year revenue for a typical HLC was really \$249,000, less than half his given projection. "According to what he learned, a mature location had average revenue in the low \$400,000s."¹⁶⁰ He believes that his loan was reversed-engineered with false information to qualify for the \$300,000 SBA loan.¹⁶¹ To qualify for a guarantee from SBA for a \$300,000 loan, the franchise owner would need a revenue estimate of more than \$500,000. HLC collected a \$60,000 franchise fee. Some franchise owners filed for bankruptcy.

Commenter to the FTC, Connecticut: *"Just imagine you receiving a phone call out of the blue from someone you've never met and being asked how much money you make....[N]OT ONE franchisee told me the truth. NOT ONE. Why? First, because they weren't going to tell a complete stranger their income. Second, because they didn't know if I was a fake call from the franchisor testing them to see if they were bad mouthing the system and 'denigrating the mark' - which is a major default in the franchisors eyes."*¹⁶²



Quiznos

In 2008, there were nearly 5,000 Quiznos franchise restaurants, but as of the end of 2018, only 306 stores survived.¹⁶³ Since 2000, Quiznos has been the target of at least five class action lawsuits filed by franchise owners.¹⁶⁴ Quiznos owners complained for years about the company charging too much money, not just for ingredients but also for any other item the restaurants needed. In court, Quiznos admitted that it sold franchises to entrepreneurs who had "little or no relevant experience," which often led to restaurant failures that harmed the brand and the rest of the chain.¹⁶⁵ Additionally, Quiznos contracts required franchise owners to pay 7% in royalty fees and another 4% for advertising — rates higher than the industry average of 6% in royalty fees and 2% for marketing.¹⁶⁶ After filing for Chapter 11 bankruptcy, Quiznos began lowering the costs of ingredients.¹⁶⁷

Bhupinder Baber owned two Quiznos franchises in 2006: *Mr. Baber committed suicide in his store, despondent over his future. In the note he left behind, he wrote, "Someone must do something about what Quiznos is doing to the trapped franchise owners.... I deeply regret getting into Quiznos. I wish I had never heard of them."*¹⁶⁸

Massage Envy

When the Federal Trade Commission requested comments on its Franchise Rule, Massage Envy franchise owners submitted the most comments. The nearly four dozen Massage Envy commenters — and others who did not comment to the FTC but spoke to Senator Cortez Masto's staff — allege that mismanagement of a new point-of-sale system, problems with gift cards and holiday promotions, required sales of inferior skin care and other products that do not sell, overpriced goods including liability insurance and technology systems, and unrealistic revenue projections have been financially damaging to their businesses. Massage Envy corporate leaders were the only corporate leaders of any of the named franchise corporations to respond to the request to speak with Senator Cortez Masto staff. The company alleges that most franchise owners are doing well and have no complaints with how the franchise operates; they also sent a letter signed by an affiliated franchise owners' advisory board that supported franchise leadership.¹⁶⁹

Founded in 2002, the Massage Envy franchise has more than 1,100 locations employing 35,000 individuals.¹⁷⁰ While the company was initially ranked as one of the best investments by sources such as *Forbes* and *Entrepreneur* and long-time franchise owners were happy with the brand¹⁷¹, however, when the company sold to a new investment corporation, some franchise owners reported a dramatic loss in revenue. Massage Envy franchise owners told the FTC about a litany of problems they allege harmed their ability to be profitable. These include requirements to purchase overpriced and inadequate liability insurance from brokers affiliated with Massage Envy.¹⁷² One owner reported paying three times as much for coverage as she could have gotten at a different insurer.¹⁷³ Franchise owners also report being overcharged on design "help"; marketing costs; unwanted and poor quality creams, lotions, sunscreens, and massage machines; and technology



systems. Some franchise owners allege that changes to Massage Envy's Operations Manual severely impacted business owners and their ability to succeed by requiring additional payments for a variety of reasons from the franchise owner to the corporation.¹⁷⁴ They report being forced to comply with these requirements at the risk of losing their ownership of stores.¹⁷⁵

Anonymous, Southern Franchise: *"I purchased [my two locations] in 2015 as high-performing clinics. [When the brand sold to a new owner, profits moved from the owner to the corporation] They have rolled out new services, one after another, with zero accountability for their success or failure. Each is designed to be a revenue stream for [Massage Envy Corporate], regardless if it is for us (and almost all have failed). When a new service/product doesn't sell, they then create a national promotion that requires us to give it away. Massage Envy required we relinquish our individually-owned internet accounts which averaged \$100/month and use their third party vendor, hardware and point-of-service program which is more than \$1,200/month. The vendor provides inferior service including inaccurate reporting and billing and poor response time."*

V. Four Factors Leading to Franchise Failures

While some may argue that no one makes someone buy a franchise and that franchise owners bear the responsibility to avoid problematic brands, it can be difficult for franchisees to avoid companies that might treat franchise owners unfairly.¹⁷⁶ Companies also change; they may go public or be bought by private equity. With ownership and leadership changes, profitable brands can become problematic. Federal and state governments have laws prohibiting unfair, deceptive, and fraudulent practices to ensure people entering business contracts receive fair treatment. Franchise owners who feel they have been treated unfairly have the option to hire an attorney and participate in arbitration or litigation – and some do – but too many lack the funds to do so after spending savings to rescue their businesses and avoid bankruptcy.

This section highlights four factors in franchise relationships that may lead to failure for the franchise owners – no matter how hard they work or how closely they follow the franchise plan. Some of these problems are due to contract terms within the FDD, which some franchise investors do not realize is not a government-approved and vetted document. The four factors include:

- Unfair contracts and agreements.
- Inaccurate financials.
- Overpriced or missing services.
- Requirements to buy from preferred vendors and resulting kickbacks.



Unfair Franchise Agreements Allow Franchise Corporations to Retain Excessive Control

Franchise corporations market the franchise as a way to “own your own business.” Yet franchise contracts may give nearly all power to the franchise corporation. Clearly, franchise corporations must be able to set a certain standard of performance in order to maintain the brand’s consistency and quality; they would not want customers to walk into a hamburger restaurant and find bicycle repair services. However, some franchise corporations may use contract provisions in ways that are abusive or deceitful. These contracts make it impossible for franchise owners to survive and to pay fair wages and benefits to workers.¹⁷⁷

Franchise agreements that include the following elements are fraught with risk for franchise owners:

1. **Preventing franchise owners from forming associations.** Associations allow franchise owners to collaborate and share information that could make their stores and the franchise brand stronger. Yet some franchisors discourage these associations, even going so far as to retaliate against franchisees who join them. For example, the CEO of Dickey’s Barbecue described franchisees who shared their concerns and participated in an independent association as having “loud, negative voices ... with fierce hatred ... and being cynical, envious.”¹⁷⁸
2. **Banning free speech.** Franchise corporations sometimes include language requiring non-disparagement and non-disclosure requirements. While disgruntled franchise owners could cause problems for a brand, this language prevents future investors from learning the truth about an investment while doing their due diligence. Some franchise corporations, in lieu of providing financial data, provide prospective owners with a list of other franchise owners to contact. But contracts with non-disparagement clauses may inhibit franchise owners from speaking honestly about their business, even to potential new owners. Current franchise owners may not tell the prospective franchise owner the truth, either because they fear legal action or they just do not feel comfortable sharing how much they earn. In one instance, a prospective Huntington Learning Center franchise owner reported calling every franchise owner on the list provided by the franchise and receiving assurances that the profits he was provided were accurate.¹⁷⁹ After buying the franchise, he learned that the other franchise owners had lied to him, including one who was actively in bankruptcy; none felt able to tell him the truth because their contracts contained non-disclosure/disparagement clauses.¹⁸⁰
3. **Requiring mandatory arbitration clauses.** Mandatory arbitration clauses can prevent franchisees from getting their day in court. Arbitration gives franchise corporations a home-field advantage, which is very difficult for a franchise owner to overcome. A 1998 *Fortune* article highlighted Subway’s particularly egregious practices around mandatory arbitration of disputes.¹⁸¹ More than twenty years later, arbitration remains a pervasive problem for Subway franchise owners. In 2017, Subway took 955 actions



against franchise owners including 702 against U.S. franchise owners; in 2018, Subway initiated 718 arbitration actions against franchise owners.¹⁸² In contrast, there was one arbitration action by McDonald's, two by Dunkin', and none by Pizza Hut, Burger King or Wendy's.¹⁸³

4. **Including clauses allowing for changes to rules.** Franchise agreements often include language permitting the franchise corporation to change rules at any time and for any reason. These rule changes typically occur in the Operations Manual; franchise contracts require franchise owners to follow the most recent Operations Manual. An Operations Manual change may be needed, as when Burger King introduces a new sandwich and franchise owners need to offer it. But some franchisors have used it in far-reaching ways, such as requiring new store remodeling policies or imposing limits on the sale of franchises.¹⁸⁴ When a new owner took over the Curves women's gym corporation, franchise owners were forced to sell food and clothes and buy new, overpriced, and unnecessary equipment. They were also required to permit reciprocal memberships that allowed a client to join a lower-cost gym but have access to a higher-cost one.¹⁸⁵
5. **Requiring franchise owners to stay open hours that are not appropriate for them.** Some contracts require franchise owners to provide services at late hours that are not profitable, and in some cases, not safe for the community. When corporations require stores to be open late at night or all night, provide breakfast service, or stay open on holidays, they undercut the ability of franchise owners to own and control their businesses. Franchise owners operating 7-Eleven are obligated to be open 7 days a week, 24 hours a day, 365 days a year, including Christmas Day.¹⁸⁶ This policy was implemented through clauses requiring compliance with the Operations Manual, which in effect changed the terms of the original contracts. In another example of the risks of these clauses, during the coronavirus pandemic, franchise owners that closed or limited hours due to government-ordered shutdowns were told they were in violation of their contracts and would be registered as non-compliant unless they agreed to contractual changes or signed releases.¹⁸⁷
6. **Requiring franchise owners to accept unprofitable prices and promotions.** Some promotions – Subway's \$5 foot longs or \$2.99 6" subs, Burger King's \$6 box, or various franchises' \$1 menu items – cost franchise owners money. Franchise owners do not want to be forced to offer food that costs more to make and serve than they earn or to accept gift cards that provide them no revenue. For example, Dickey's Barbecue Pit offered gift cards that were not functional; the card always appeared to have money available even when it had been spent, and so the franchise owner received no payments on these gift cards.¹⁸⁸ Conflicts over promotional pricing that increases revenue but reduces profit is common in the franchise industry, because most franchisors make their money based on a percentage of the sales revenue, even when franchise owners are left with little or no bottom-line profit.¹⁸⁹ These deep discounts drive low wages in the industry and limit philanthropic community support.



In fact, franchisors often calculate break-even points based on the revenue required to hire employees at the minimum-wage.¹⁹⁰

7. **Allowing corporations to easily seize franchise stores.** Franchise owners have complained that Subway's business practices allowed regional store owners to seize their stores.¹⁹¹ At Subway, the regional Business Development Agents (BDA) are responsible for inspections of the stores in their territory. Inspectors or Field Consultants sent by BDAs would write up stores for violations. Multiple violations reported by a single Field Consultant can put a restaurant into termination in a few months, with no one confirming that Field Consultant's work. If the restaurant is terminated, the franchise owner is often given a short timespan to sell the franchise. However, the BDA must also approve any buyer. If no buyer is found or approved, the BDA can then buy that restaurant, often at a discounted rate. This creates a system that has great potential for a conflict of interest and corruption. In another example, 7-Eleven franchise owners believed that the corporation was working with federal immigration agents to request raids as a tool to seize stores from owners.¹⁹²
8. **Limiting store sales.** Some franchise agreements require a franchise owner to walk away at the end of the contract term with no payment for their decades of work building up a franchise brand. Franchise owners should be able to receive some equity from their investment—also referred to as monetized equity. Other franchisors refuse to easily approve sales from one franchise owner to another. In one instance, a franchise owner of a restaurant in California needed to sell her store to take care of her dying child. She alleged that the regional Development Agent (DA) refused to approve the owners she recruited, instead dragging out the process as she continued to lose money. Finally, after months without agreement on buyers, the DA bought the store himself at a price lower than those of previous interested buyers. The time delay resulted in her losing her family's home, where she had memories of her now-deceased daughter.¹⁹³ In addition, some franchise contracts include non-compete requirements that make it more difficult for a franchise owner to start a new business in their area of expertise.

Missing or Misleading Financial Disclosures

When selling a franchise to an investor, a franchise corporation has the obligation, if financial representation information is provided, to include historical financial performance, without any false, misleading, or unsupported information. Prospective franchise owners rely heavily on these representations in the FDD when choosing whether to invest in a business. Franchisors and their trade association, the International Franchise Association, often claim that owners fail to do their due diligence in carefully studying the FDD. Yet the FDD can be hundreds of pages and written in an unclear or unbalanced way. Item 19 of the FDD, where the franchisor can make claims about the income, sales or earnings of its stores, is not required, and even when it is present, it can omit critical data.¹⁹⁴ Franchise owners can be discouraged from spending money on an independent attorney to review the contract; they are often told by corporations not to waste their money on such review because the investment is vetted by the federal government—a false assertion.¹⁹⁵



A 2013 Government Accountability Office (GAO) study found that franchisors often leave financial performance data out of the FDD.¹⁹⁶ A 2011 audit conducted by the SBA Office of the Inspector General found that when franchisors did include revenue projections, they could be significantly higher than historical actuals.¹⁹⁷ The FTC's website notes that financial disclosure claims can be easily distorted to provide a rosier outlook than the reality.¹⁹⁸

Deception can include failing to provide information to determine how performance data was calculated or about how many stores achieve a given level of earnings. Reported average income can also be skewed higher by only selecting a few high-performing franchises. Gross sales may not reflect actual costs or profits of the average franchise. Without an accurate financial picture, potential franchise owners are unaware of the real costs and profits associated with a business.

Notably, lenders require accurate financial performance data to determine loan type, amount, and payment schedule, and at times, they receive it directly from corporations. Lenders have incentives to make loans that they suspect will fail because lenders make money on the fees and collateral and are likely to get the majority of their money back through SBA guarantees. Bank regulators do not monitor government-guaranteed loans made by banks and other lenders. Lenders may also sell the loan to investors, as SBA loans can be packaged and sold as government-guaranteed loans on the secondary market. The SBA and its Office of Inspector General have been lax in holding lenders and franchisors accountable.¹⁹⁹

Franchisees can be oblivious about crucial financial performance information about the business they are investing in, even though this same information is compiled and distributed to their lenders. As the author of a law review article put it, "One of the ironies regarding [financial performance representations] is that even those franchisors that do not make FPR claims in their FDD must often create and distribute those exact same numbers to the financial institutions of prospective franchise owners seeking financing to purchase the franchise."²⁰⁰ Because the franchise owners are often unaware of these numbers, the owner cannot later determine whether false financial data was given to a financial institution to qualify for a loan the franchise owner must repay. The franchise corporation is generally the party with more business experience. The corporation has a duty of due care to ensure that all relevant information, including accurate financial performance, is provided in the Financial Disclosure Document (FDD). Moreover, franchise corporations can partially protect themselves from being held accountable for misrepresentations by providing inaccurate misrepresentations outside the FDD – a loophole that can cost franchise owners dearly. If the FDD contains no financial information in Item 19, but provides financial information in another manner, the franchise owner is not supposed to rely on that information in making its decision. But that is often unclear to the franchise owner, who often receives revenue numbers from other franchise owners, salespeople, franchise corporation-provided loan consultants, and articles or newsletters.



Overpriced Fees and Missing Services

There is a cost to purchasing and operating a franchise. Franchise owners are required to pay initial fees, renewal fees, advertising fees, and royalty fees. Initial franchise fees can be as low as \$15,000 or upwards of \$60,000 or more. Royalty fees are typically around 4 – 5% of gross sales, but can go up to 8% or more. Advertising fees can add 1-2% for some franchises, or up to 4.5% or more. Some franchise owners complain that they received no follow-up assistance to set up or manage the business after the sale was concluded.²⁰¹ Others report paying fees for marketing, computer, or training services that are never provided, and certainly not reported in a transparent manner.²⁰²

- 7-Eleven is unusual in requiring an ever-increasing gross profit split. 7-Eleven now requires franchisees to give the corporation as much as a 59% share off the top, even as franchise owners must absorb higher operating costs. Franchise owners complain that they cannot renew their contracts without accepting these higher profit splits and other requirements related to hours and product sourcing.²⁰³ In addition, 7-Eleven franchisees never actually own the businesses; they hold no title to their store, even though they paid for everything.
- Burgerim franchise owners reported being asked to pay \$5,000 for a loan consultant who provided what franchisees allege was no services. Burgerim franchise owners were also charged \$50,000 per franchise location but report receiving none of the promised assistance, training, or materials.²⁰⁴
- Dickey's Barbecue Pit franchise owners complain that, over the past five years, more than \$52 million has been paid into the corporation's marketing fund by franchise owners.²⁰⁵ Although the marketing fund is entirely financed by franchise owners, Dickey's has full discretion and control over how this budget is allocated for the purposes of advertising; the company's only real limitation in using the marketing fund is that it is prohibited from spending the budget on its own general operating costs or for franchise owner recruitment. However, these prohibitions can be loosely applied. For example, expenses for an executive traveling to a region may be charged to the marketing fund because the executive is "promoting the brand". In its agreement terms, Dickey's explicitly states that application of the marketing fund will not be used to promote individual franchise sales specifically, but instead to create campaigns at the national level, which may benefit franchise sales indirectly. Because Dickey's decides where all of its advertisement projects are publicized geographically, the company will not necessarily make expenditures that are equivalent or proportionate to an individual franchise owner's 4% marketing fund fee contribution. Thus, some franchise owners may receive no marketing benefits at all; furthermore, owners have complained that most local advertising purchased in the franchise owner's market is ineffective because it is often organized by a promoter who is unfamiliar with the relationships between restaurants and their local communities.²⁰⁶



Requirements to Buy from Preferred Vendors and Resulting Kickbacks

Most franchises require franchise owners to receive their products from preferred vendors. They may require franchise owners to build their stores with preferred architects and contractors. While such an agreement may make sense in order to achieve a consistent aesthetic or meet safety standards, those costs can be inflated.²⁰⁷ In addition, some franchise owners complain that beverage and food companies provide rebates to the franchise corporation, but not to the franchise owners who are paying the bills.²⁰⁸ When franchise corporations talk to prospective franchisees, they often state that one advantage to buying a franchise is the group purchasing power. This claim of group discounts is one of the biggest myths in the franchise industry. These vendor rebates become nothing more than indirect royalties to the corporation.²⁰⁹

- Store owners report that their required suppliers provide rebates directly to 7-Eleven.²¹⁰ Franchise owners say there is no guarantee that the cost of goods they receive from the 7-Eleven supply chain will be lower than what they could buy at a local big-box retailer.
- Curves gym owners reported being forced to purchase flat-screen TVs, new exercise equipment, clothing, clothing racks, food, and other unnecessary and overpriced materials from preferred vendors.²¹¹
- Massage Envy franchise owners were required to sell various lotions and massage equipment even if their clients were not interested in making such purchases.²¹² Massage Envy franchise owners also stated they were forced to purchase overpriced and inadequate liability insurance.²¹³ Other franchise owners report being forced to use specific architects whose services cost twice as much as a local architect.²¹⁴ Massage Envy corporate leaders dispute these allegations made by more than a dozen franchise owners.



VI. Solutions: Establish Fair Franchise Practices

Below are recommendations that Congress, federal agencies, state governments, and the franchise corporations and owners themselves can follow to ensure franchise owners are being treated fairly. These policy changes include greater disclosure, fair contracts, stronger government oversight over federal dollars, and robust enforcement against bad actors.

What Franchise Corporations Should Do

All of the problems detailed in this report could be fixed by the franchise corporations and their trade association, the International Franchise Association (IFA). IFA should establish best practices and guidelines for fair trade and marketing practices. Many of these suggestions – for fair contracts and revenue disclosure – come from the franchise owners themselves.²¹⁵ The Coalition of Franchisee Associations highlights 13 specific recommendations, such as freedom of association, fair dealing, and right to earn equity in a business as well as others such as encroachment, right to price, and right to transfer a franchise to a qualified purchaser.²¹⁶ Even if Congress, state governments, or regulators fail to act, franchise corporations and franchise owners should work together to make these improvements. Franchise corporations should support policies that treat their franchise owners as their critical customers. Franchises that make money on selling franchises, not on the success of the franchise over the long term, should be exposed and sanctioned by the franchise trade association. The sector could also mandate licensing requirements with annual educational requirements for franchise brokers, consultants, and salespeople. This could be similar to the real estate industry and would include a fiduciary responsibility to the prospective franchisee with whom they work. Franchise corporations and owners should work together to preserve their businesses and improve their economic resiliency for the future.

What Can Congress Do?

Franchise issues have been a long-standing concern for Congress. In the 1990s, Congressman John LaFalce (D-NY), Chair of the House Small Business Committee, repeatedly introduced the Federal Fair Franchising Practices Act. The bill would have allowed a private right of actions for damages and recovery of attorneys' fees, and it would have permitted actions by state attorneys general. The bill would also regulate both disclosure and the franchise relationship, address fraud, address discrimination in the sale of franchises, and regulate termination and cancellation, purchasing requirements, non-competition clauses, fiduciary, good faith and due care duties, encroachment, and mandatory arbitration. Congressman LaFalce was unable to pass it after the control of the House changed in 1995 and he was no longer Chair of the Small Business Committee. Then, in 1999, Representatives Howard Coble (R-NC-6) introduced the Small Business Franchise Act of 1999 (H.R.3308). During the 114th – 116th Congresses, Representative Keith Ellison (D-MN-5) introduced two franchise bills, the Fair Franchise Act and the Small Business Administration (SBA) Franchise Loan Transparency Act. Senator Catherine



Cortez Masto (D-NV) introduced a revised version of the SBA Franchise Loan Transparency Act (S. 2383) in the 116th Congress.

In 2019, the Economic Policy Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs held a hearing on economic mobility that included a witness who described concerns with franchising.²¹⁷ In response to constituent complaints, and the witness at the hearing, the Cortez Masto personal office staff began research into the governmental role related to the franchise sector, research that resulted in this report. At a 2020, House Energy and Commerce hearing, FTC Commissioner Rohit Chopra raised concerns about franchise practices and has continued to do so in many venues.²¹⁸ In 2020, numerous legislators submitted letters regarding franchising to the FTC and SBA.²¹⁹

Congress should strengthen laws to improve the franchise process from inception to the end of the contract term and provide adequate funding for agencies charged with ensuring fair treatment. For example, the Federal Trade Commission needs full-time staff dedicated to providing oversight of franchise businesses. Legislation should:

1. **Require Disclosure of Financial Performance Data.** Many investments, such as stocks and bonds, require that prospectuses include accurate costs and historical performance data; franchises should be required to provide this information as well. Congress should enact laws that require disclosure of financial performance information by franchise brand for all SBA-guaranteed loans. The FTC should require that all FDDs include accurate and comprehensive financial performance representation data in Item 19. Franchise owners seeking an SBA loan should receive accurate first-year and historical revenue data and store closure information, including closures within the first 12 months. These disclosures would ensure that franchise owners get needed information and are not misled by corporations or salespeople providing false or skewed numbers. Congress should also require SBA to publish loan performance data for all franchise brands. Default rates could be published within 72 hours of learning of a default. The technology exists for lenders to provide accurate real-time reports available to the public. Franchises with high levels of defaults are risky for investors and the government. Timely reporting is an investor protection. Lenders that fail to report should be disqualified from receiving a loan guarantee. Such disclosures would result in fewer government payouts for failed loans.
2. **Provide for a Private Right of Action:** The FTC currently lacks adequate resources for a robust franchise oversight office, nor does it prioritize enforcement of the Franchise Rule. Adding a private right of action to the Franchise Rule would provide franchise owners the right to sue franchise corporations for Franchise Rule violations.
3. **Ensure Fair Treatment:** Although federal agencies like the FTC and SBA can require that contracts exclude problematic language and challenge unfair practices, Congress should enact legislation that ensures fair treatment.



These provisions include:

- a. Allowing franchise owners to form associations without interference or retaliation;
- b. Prohibiting non-disparagement clauses that prohibit potential franchise owners from learning about the business from current franchise owners;
- c. Ensuring contracts include a private right of action guaranteeing franchise owners a day in court if problems arise;
- d. Providing termination rights to franchise owners to ensure due process is afforded to all franchise owners when exiting a contract; and
- e. Providing transfer rights to ensure that franchise owners can transfer property and monetize the equity they have earned.

What Can the Federal Trade Commission Do?

The FTC should follow up on its recent efforts to strengthen the Franchise Rule and improve the Franchise Disclosure Document (FDD) to ensure FDDs provide accurate data to potential franchisees in addition to requiring more accurate disclosure and fair treatment in general. The FTC should:

1. **Include a Summary or Overview.** Provide an overview or summary on the first page of the FDD that has the basics any franchisee should know, including franchise financial performance, store openings, store closings, and sales and revenue information, as well as a description of what support the corporation provides franchisees and what responsibilities franchisees have. The FTC should convene a working group to develop this summary. The summary/overview should be available in addition to the FDD rather than replacing it.
2. **Require Financial Performance (Item 19) be mandatory.** Ensure all FDDs include historic financial revenue information for all franchise businesses in Item 19 in accordance with the North American Securities Administrators Association (NASAA) Financial Performance Representations Commentary.²²⁰ Item 19 should include disclosures on revenues, costs, and other data for both first-year stores and mature stores. In addition, Item 20 should include the number of outlets that closed during the first 12 months; first-year store closings are not contained in Item 19.
3. **Ensure Access to All Materials.** Mandate that all information related to the franchise that is shared with lenders, consultants, brokers, or other third parties must also be made available to the franchise investor/owner. The FTC should also impose a licensing requirement and fiduciary responsibility for third-party franchise brokers, consultants, and salespeople that engage in the sale of franchises.²²¹



4. **Require Fair Contract Terms.** Ban the inclusion of non-disparagement clauses and mandatory arbitration clauses in the Franchise Agreement, as well as clauses that prohibit franchisee associations. Franchisees should not lose their free speech rights, their right to litigate a dispute, or their right to freely associate with other franchise owners as part of their franchise agreement. In addition, franchisees should be given a private right of action, so that they can litigate violations of the Franchise Rule.
5. **Ban Some Disclaimers and Questionnaires.** The FTC should prohibit FDDs from including disclaimers that allow franchisors to amend their policies outside the specific language of the franchise agreement that has been disclosed in the FDD, such as by making changes to the Operations Manual that are contractual, not operational. FDDs should not include language that effectively permit franchise corporations to change contract terms at will. Any required changes should only be directly related to daily operations, such as the recipe for a new menu item. The FTC should also require any questionnaires be provided with the initial FDD. The franchisor should not be permitted to change any practice from the initial FDD without a vote of the franchise owners. The FDD should also ban questionnaires and disclaimers that are used by franchisors to avoid responsibility for contract disputes. No questionnaire or disclaimer should be used to avoid a claim of deceptive practices of fraud by a franchise owner.
6. **Protect Limited English Proficient Investors.** If a franchise markets to people in a language other than English, the franchise company should be required to provide the FDD in the language of the people to whom they are marketing. For example, some bubble tea, nail salons, and cleaning services market to potential franchise owners in languages other than English. The FTC should work with state governments to establish an oversight capacity for FDDs in languages that are not in English.
7. **Ensure FDDs are Publicly Available on the FTC website and Require FDDs Be Made Available Online and Searchable.** FDDs must be available on the FTC or franchisor website. Basic data regarding revenue, expenses, and rules should be easily searchable from within the document. The Securities and Exchange Commission's in-line XBRL provides a model.²²⁷

Congress should provide the FTC the resources it needs to develop a more balanced FDD that ensures fairer contracts for franchisees. The FTC should not only improve the Franchise Rule but also use its powers under Section 5 of the Federal Trade Commission Act, which prohibits "unfair and deceptive acts or practices in or affecting commerce."²²⁸ Hardly any enforcement actions have been taken against the numerous franchises that have allegedly engaged in unfair and deceptive practices. The FTC should dedicate enforcement staff to investigate mistreatment of franchise owners. The FTC should recognize that even a moderate volume of complaints can still signal a significant problem.



A franchise brand with fewer than 100 outlets is unlikely to ever meet the volume of complaints for the FTC to consider it a big issue. However, while the volume of complaints may be small, the FTC needs to take into account the size of a franchisee's investment and the level of risk for the franchisee when determining investigation and enforcement priorities. When sixty entrepreneurs lose tens of millions of dollars in a failing franchise, the FTC should investigate. The FTC should ensure that any penalties assessed take into account the damage done to franchise owners.

What Can the Small Business Administration Do?

The Small Business Administration (SBA) plays both an instrumental and an insidious role in franchise lending. About 13 percent of SBA guaranteed loans are made to franchisees. These loans make it possible for many people to buy and operate a franchise. In many cases, these are success stories and examples of government funds helping business owners. However, the opposite is also true; the SBA has been the enabler for some problematic franchise brands.²⁰⁴ Franchise corporations have learned how to grow quickly without accountability, by helping franchise owners who cannot get private financing to obtain an SBA loan with financial data that may be overly rosy, leading to defaults and bankruptcy for the franchise borrowers.²⁰⁵ With taxpayer dollars on the line, the SBA must demand higher due diligence for any loan it guarantees.

The SBA should:

1. Require that any franchise owner receiving an SBA loan receive disclosure of average and median first-year revenues for franchise outlets, average and median revenues for all outlets, and total number of franchises that closed or were transferred overall and within the first year.
2. Prohibit the franchise corporation from disclosing to a prospective or current franchisee, either directly or through a third party, any information relating to revenue that conflicts with the information provided in a disclosure document.
3. Publish the number and amount of loan defaults by the franchise brand on the SBA website.
4. If the FTC does not make the recommended changes to the FDD to protect franchisees, the SBA should require those elements be included or excluded from the FDD where appropriate for any loan the SBA guarantees, in order to ensure the ability of the franchise owner to repay the loan.
5. Establish a franchisee help line to work with franchise owners facing issues. Too often, franchise borrowers must fend for themselves, including during a systemic failure of the franchise brand.



6. Take legal action against franchise corporations that provide inaccurate financial data to a franchisee and, where appropriate, hold the franchisor liable for the balance of any loan made if the franchisor did not follow the law.

What Can States Do?

Franchising is principally governed by state contract and business laws, which are not consistent across states. Typically, a private party is responsible for enforcing their own contract and commercial rights through civil proceedings. However, franchisees are essentially business consumers, a constituency protected by state consumer protection laws.

At the outset of oversight, some states require franchisors to register an FDD with the state prior to making an offer or sale to prospective franchisees. These states are referred to as "franchise registration states" and include California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, Virginia, Washington, and Wisconsin.²²⁵ Some franchise corporations avoid doing business in these states to avoid registration and the transparency that comes with it. If more states adopted similar laws, it would provide franchise owners with another layer of legal protection.

Chart 10: Map of Franchise States²²⁷

MAP of Franchise States



There are also 19 states that have some form of relationship laws that take into account the period after the franchise contract. These relationship laws vary from simple statutes that cover a few issues to more comprehensive regulation offered in states like California, Minnesota, or Washington, for example. Unfortunately, even the most stringent state regulations fail to cover many of the issues brought forward in this report. All states should enact greater investor protections and prioritize enforcement in response to allegations of fraud or deceptive practices. In the past fourteen years, only state regulators have taken enforcement action on a franchise matter.²²⁸



VII. Conclusion

In the past few years, numerous complaints about the practices of some franchise corporations have been reported to state governments, Congress, and federal agencies. Alarming media stories, despondent calls and letters from franchise owners, comment letters to the Federal Trade Commission, and worrisome franchise loan performance data all point to the need for action to curb these problematic practices. It is clear that federal and state agencies are not doing enough to ensure fair treatment of investors in franchise models. This not only leads to a plethora of failed businesses but also waste, fraud, and abuse. From losses on government-guaranteed loans to unemployment benefits for franchise employees, taxpayers bear part of the burden of these problematic franchise practices.

The franchise business model can and should be a model for economic mobility and for individuals to realize the American Dream. A fair franchise system will lead to higher wages for employees, more secure investments for franchise owners, and more stable businesses in communities. However, an unchecked industry has damaged the finances of owners and workers while franchise corporations continue to earn profits.

Congress should use the appropriate power of federal and state government regulation and enforcement to enhance and protect free and fair markets for the franchise owners, their employees, and their communities. The franchise corporations should partner with the franchise owners to create a fairer and more profitable system for all. As people work to rebuild in the wake of the COVID-19 pandemic, the franchise model will tempt many as an opportunity for financial success; it would be a travesty if some of them found themselves trapped with franchise businesses that resulted in financial devastation that could be easily avoided if franchise corporations followed the guidelines for fair treatment recommended in this report.

VIII. Special Thanks

The Office of Senator Cortez Masto is grateful to the many franchise owners, both in Nevada and across the country, who reached out to share their stories. Special thanks to Keith Miller of Franchisee Advocacy Consulting, Federal Trade Commissioner Rohit Chopra, Sam Levine, Theresa Leets, Elise Bean, Michael Hataway, Vishal Sharma, Mark Shor, Jay Hackstaff, Gina Siepierski, Megan Edwards, and the dozens of franchise owners who spoke out to protect future franchise investors. We hope others reading this will be inspired by your courage and take action to prevent unfair franchise practices in the future.



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³² Martin Cordell, Theresa Leets and Warren Lee Lewis. "Responding to Franchise Enforcement Actions." American Bar Association 43rd Annual Forum on Franchising, October 27-30, 2020.

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Notice of Partial Dismissal on September 16, 2015 and agreed to have their action transferred to the U.S. District Court, Western District of Texas, Waco Division and assigned Case No. 6:15-cv-00294-WSS. In their action, franchisees and former franchisees allege that they were induced to buy a Curves franchise by false and misleading information provided by Curves International, Inc. in violation of the Texas Business Opportunities Act and the Texas Deceptive Trade Practices-Consumer Protection Act. Additionally, plaintiffs allege that once they began operating their franchises, Curves International, Inc. violated the implied covenant of good faith and fair dealing and breached their contracts by not providing assistance, concealed facts and took affirmative actions that hurt each plaintiff, all in violation of the Texas Business Opportunities Act, the Texas Deceptive Trade Practices-Consumer Protection Act, and Federal Trade Commission Regulations. This lawsuit went to trial on April 10, 2017. The jury returned a verdict in favor of the plaintiffs. The parties entered a settlement agreement wherein Curves International, Inc. settled with each plaintiff.

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x. Appendix I: Comments Regarding FTC Franchise Rule Submitted in Fall 2020 Comment Period

Below are summaries of some of the comments to the FTC during a 2020 comment period regarding feedback on and changes to the Franchise Rule. These comments discuss problems with franchisors, the current functioning of the Rule, and proposed changes or amendments. These comments note individual letters but do not include the mass campaigns from Subway (75 comments); 7-Eleven (9) and Massage Envy (31). The comments are organized by state and indicate the franchise the comment pertains to, if available. The full comments are available online at <https://www.regulations.gov/document/FTC-2020-0064-0001/comment>.

Arizona

- **Subway** - Owner requests the FDD disclose regions vs owners when disclosing production.

Arkansas

- **Massage Envy** - Franchise owner owns two stores in Arkansas with 48 employees. Given inaccurate financial information, asked to make investments that were not disclosed in the FDD, had to use certain vendors and suppliers that were too expensive, made changes to the operations manual, and objected to a misused marketing fund that is ineffective.
- **Massage Envy** - Franchise owner has two locations in Arkansas purchased in 2015. Starting in 2016, ME made changes to the company that decreased EBITDA. Required renovations were non-disclosed and expensive due to required vendors. The national marketing co-op has no accountability or benefits. New required services and products hurt franchisees. Highlights products that were expensive and auto shipped that clients didn't want. A required insurance vendor is more expensive than the open market and a compliance vendor is overpriced. Operations Manual has been used to change the franchise agreement. Still has high gross revenue, but business is not profitable and may not survive the year. FDD does not indicate the problems with the franchise and that revenue is not based on success but various vendor streams.
- **Unnamed franchise** - franchisor forces franchisees to buy products that franchisor gets a rebate/kickback on and requires liability insurance that puts all the liability on the franchisee. FDD is an example of hiding things in contracts. Financial data is useless because it is "averaged out" and profits/break evens are overstated.



- **Choice, Wyndham, Red Roof, Hilton, Radisson (Hospitality Brands)** - Franchisee of multiple hotel brands. Argues that hotel franchises double dip fees, vendor exclusivity eats into profits and franchisor gets rebates/kickbacks, franchisorforbids class action lawsuits, institutes unreasonable mandates (like remodels and brand refreshes), allows franchisees to compete in territories, and sells loyalty points to generate cash.

California

- **Curves** - Discusses the impact of a private equity firm purchasing Curves - highlights a class action lawsuit and the lack of settlement funds. Advocates for franchise owners to be treated as shareholders, including the right to vote, quarterly and annual shareholder reports, ability to sell ownership at will without penalty if there is a change in corporate leadership and ownership.
- **Dental Fix** - Had to declare bankruptcy after buying a Dental Fix franchise when it failed after less than two years.
- **Dental Fix** - Dental Fix has been bad for their lives and livelihoods - wants to make sure it doesn't happen to anyone else.
- **Massage Envy** - Supports the SBA Franchise Loan Transparency Act of 2019 – argues that if these provisions were in law, this franchise owner would not be ruined financially. Discusses how her Massage Envy closed within 11 months of opening. Argues that projections used to estimate SBA loan were incorrect, inaccurate, and unachievable. Invested over \$250,000 until they ran out of money. Discusses how hard it was to end contracts and the additional \$80,000 spent to exit contracts.
- **Massage Envy** - Owns two Massage Envy stores in California - sent a letter to the corporation requesting a return of investments. Business has had three bankruptcies in their region. One third of area units are not making money and were sold to new owners at a loss. Highlights problems with Massage Envy's management. Claims erosion of profit margins, bad vendors, unauthorized fees, misspent advertising and marketing fees, and nonresponsive franchisor and representatives.
- **Massage Envy** - Owns two Massage Envy locations. Highlights oversaturation of market with locations, inaccurate point of sale system that is flawed and overpriced, force-shipped retail products, and a shortage of massage therapists. Discusses franchisor's deals with required vendors that sell products at prices more expensive than the open market. Fellow franchisees in area have not achieved EBITDA or profit, with many closings and bankruptcies. Clinics, once resold, are cheaper than the investments. Asks FTC, SBA, banks, and other agencies to launch an investigation.
- **Massage Envy** - Discusses experience as a ME franchisee that closed. ME's business practices, in addition to COVID, led to closures. Discusses a misleading business model that did not reflect the truth. Profit generation was impossible due to corporate requirements and auto shipping of products. Discusses market saturation and recruiting challenges to hire therapists. Also discusses purchasing



supplies from specific vendors regardless of cost and a changed point of sale system that made things worse. Also discusses forced retail brands and mandatory orders for holiday and special occasions that hurt profits. Highlights required conferences and technology overhauls that hurt business more and eroded profits. During COVID closures, ME continued to collect marketing and operational fees and did not help stores that closed.

- **Unnamed franchise** - Franchisor made changes to the operations manual that impacted profit of franchisee owner.
- **Franchise Advocacy Consulting** - Discusses the receipt of financial information outside the FDD and other problems within the franchise industry. Advocates for mandatory financial representations, providing basic data for financial representations, licensing requirements for third party brokers or consultants, required disclosure on commissions, a fiduciary responsibility to prospective franchisees, and the "tightening" of information in Items 6 and 7. Recommends that the FTC needs to examine complaints differently.
- **Unnamed franchise** - Franchisors need to provide their best data to prospects and franchisees looking to expand. Franchisors must disclose changes in demographic and psychographic data that impact a location's success
- **Comment from franchisee lawyer** - who believes FTC should require mandatory profit and loss data in Item 19 disclosures, ban disclaimers outside of the FDD process and ban no-reliance clauses, acknowledgements, and questionnaires, distinguish integration clauses from no representation and no reliance clauses, and prohibit disclaimers of additional information provided by the Franchisor outside of the FDD. Argues that FDD should include executive summaries, allowing for toggling, and be part of a public database.
- **Comment from franchise attorney** - who opposes mandatory financial performance representations (FPRs), believes there should be no reliance clauses and other disclaimers, believes FDDs are not too long, does not support a summary FDD, believes there can be some changes to make it more user friendly.

Colorado

- **Massage Envy** - Owner of Massage Envy in Colorado. Given inaccurate financial information, asked to make investments that were not disclosed in the FDD, and had to use certain vendors and suppliers that were too expensive. Noted that the franchise corporations made changes to the operations manual and required contributions to a misused marketing fund that is ineffective.
- **Comment from franchisee lawyer** - who advocates for changes to the FDD (with Items 8 and 9), allowing for electronic-only FDDs with no physical or physical media copies, including a summary document, and reforming Item 19 disclosures.



Connecticut

- **Huntington Learning Center** - Highlights how SBA's loan policies have circumvented the FTC Franchise Rule. Requests franchisors provide gross revenue numbers for all first-year franchisees (and potentially second-year numbers) for the previous five years.

District of Columbia

- **Comment from franchise attorney** - FPRs should not be mandatory, should allow for disclaimers, waivers, and questionnaires, and should require a cautionary statement. Discusses pros and cons of the current FDD format and particular changes to FDD sections.
- **Comment from franchise attorney** - Argues that the Franchise Rule does not need major changes. No need for FPRs, allow for questionnaires and admonitions for disclosure, do not need to shorten/summarize the FDD, FDDs do not need to be reformatted, summary FDD does not need to be required.

Florida

- **Dental Fix** - Veteran who bought a Dental Fix said franchise ceased all support (initial training, continuing education, franchise coach, tech support, marketing, billing) within 12 months. Franchisee lost 90% of savings.
- **Experimax** - Says Experimax misled franchisee on revenue and says they were coached on how to get an SBA loan. Argues equipment was overpriced and store never performed according to the numbers that were expected. Experimax did not bring sales or merchandise support. Franchisee has now closed store and lost life savings.
- **Unnamed franchise** - Argues that financial projection requirements in FDDs would be too costly and difficult to compile and that requiring an FPR would be an impediment to franchising. Small franchises can't scale up with these requirements. At an early stage, FPR is cost prohibitive and difficult to maintain. Franchisees don't need handholding and these requirements would stifle business.
- **Unnamed franchise** - Franchisor mandates purchasing from certain vendors at higher costs. Marketing fund has no accountability, and this franchisee questions whether the fund benefits the franchisees. Franchisors are not dealing fairly and have created more brands within the company to dilute returns, increase risks, and increase fee collections.
- **Subway** - Franchisor made changes to the operations manual that impact profit.
- **Subway** - Owns six Subways in Florida - highlights mandatory, non-disclosed investments in programs and remodels, changes to the operations manual, increases in rebates and fees from required vendors, and problems with marketing fund.



- **Subway** - Highlights constant need for renovations and new programs that do not come with a business model and do not generate profit. Subway has made changes that reduce profitability. No disclosure on increased rebates from vendors – franchisee pays higher costs and fees for products. No marketing fees go towards helping franchisees.
- **Unnamed franchise** - Franchisor made changes to the operations manual that impact profit.

Georgia

- **Bruster's** - Owns a single Bruster's in Atlanta with a staff of 20. Given franchise information that wasn't included in the FDD and was prevented from using that information to make a decision. Has been asked to make investments in programs and remodels that were not disclosed in the FDD. Franchisor made changes to the operations manual that impact profit and has required increased rebates and/or fees from vendors that were not disclosed. Franchisor charges a marketing fee but does not use funds for marketing.
- **Massage Envy** - Owns four Massage Envy locations with a staff of nearly 120. Highlights changes to the FDD that include forced retail product purchases, purchase requirements from vendors that are more expensive than the open market, and changes to the operations manual. Highlights high costs for insurance through required carriers. Asks the FTC to regulate how franchisors amend the FDD.
- **Unnamed franchise** - Has owned and operated franchise restaurants for more than 15 years. Believes that franchisors do not respect the FDD/UFOC, particularly in jurisdictions with no state oversight. FTC is less likely to pursue cases with fewer than 100 plaintiffs or claims less than tens of millions of dollars. The franchisee-franchisor relationship is weighted to the franchisor and highlights bankruptcy code.

Illinois

- **Massage Envy** - Owns four Massage Envy locations in Illinois with nearly 90 employees. Highlights non-disclosed investment requirements for new programs, forced retail items, and expensive remodels. Discusses changes to the operations manual that impact cost, such as inflated insurance requirements, required supply purchases, and additional services that do not have a proven business model. Also includes required purchases from vendors and a marketing fund that is not utilized. Also highlighted difficulties with member credits.
- **Unnamed franchise** - Franchisors require costly renovations and demand capital improvement plans with no guarantees of revenue or investment.
- **Subway** - Owns four Subway franchises in Illinois with a staff of 22. Highlights investments that were not disclosed in FDD for new programs or remodels.



Kansas

- **Massage Envy** - Owns two Massage Envy locations in Kansas with 75 employees. Given inaccurate financial information, asked to make investments that were not disclosed in the FDD, had to use certain vendors and suppliers that were too expensive. Franchisor made changes to the operations manual and requires contributions to a misused marketing fund that is ineffective.

Louisiana

- **Baskin Robbins** - Discusses Baskin Robbins' rejection of franchisees' proposed relocation selections because of territory overlap or market economics. Franchisee is being asked to forfeit fees to renew the contract since they could not get a location.
- **Dental Fix** - Owns a Dental Fix franchise that makes no money. Believes they were lied to and that Dental Fix committed fraud - requests investigation by FTC, SBA, and other agencies. Lives paycheck to paycheck and has lost all retirement.
- **Experimax** - Purchased two Experimax franchises. Earnings productions were off, and claims about product availability and sourcing were not true. As a result, franchisee lost over \$500,000 and couldn't open second location. Highlights that several other franchises were forced into bankruptcy because of inaccurate projections.
- **Unnamed franchise** - Calls franchising "modern/legal indentured servitude" and says franchisee was convinced to sign on a 10-year SBA loan and 30 years of franchise fees. Business isn't profitable, royalties and fees need to be paid, and products must be purchased from certain suppliers due to contracts.

Maryland

- **Unnamed franchise** - FDD said marketing fund contributions would be used to benefit franchisees and that the franchise corporation had a board of trustees made up of franchisees. 10 years ago, this changed, and now company makes all decisions with a board containing no franchisees. Advisory board of franchisees has little/no input, and there is no accountability on how money is spent or the efficacy of disbursements. Questions whether the funds are used to benefit franchisees.

Massachusetts

- **Sanford Rose Associates International** - Franchisee alleges they were defrauded by an executive search franchise, Sanford Rose Associates International, and highlights that the FTC has a duty to protect all parties. Current franchise rule is ineffective. Franchisee highlights the ways the FDD promotes fraud, and franchisee goes on to provide solutions to support franchisees.



Michigan

- **Unnamed hotel franchise** - Longtime hotel franchisee for over 15 years. Brands double and triple dip on revenue. Franchise corporation levies fees for cost of business that are passed on to franchisees. Hotels abuse early termination fees and mandated upgrades/remodels.

Minnesota

- **Comment from franchise attorney** - Supports keeping financial performance disclosures as voluntary, should not impose further restrictions on disclaimers, and should keep FDD format with some modest updates.

Nevada

- **Be Amazed Sandwich Co** - Longtime franchisee owner who owns two different franchises - previously was an owner in three different systems. Believes there are several improvements to be made to the FDD and the Franchise Rule.
- **Unnamed franchise** - Franchisee for 26 years with different brands - currently owns two brands they have been with for 26 years and 12 years, respectively. Worked with four other brands but no longer has a franchise of those brands. Believes there is no protection for franchisees. FDD should be given out at first contact and read before discussions take place, and the FDD should disclose success rate. Argues that the Franchise Rule should be updated to include an overview/summary and mandated FPR. The FTC should make FDDs available online and searchable, protect Limited English Proficient consumers, require fair contract terms, ban some disclaimers and questionnaires, prohibit disclosures outside of third parties, and increase staff and enforcement actions at the FTC.
- **Unnamed franchise** - Franchisor requires products and services purchased from certain companies at higher markup than products available on the open market. Disclosure gives revenue amount for affiliated companies but does not give profit or markup to franchisor. Undisclosed costs are royalties to franchisor but are additional costs to franchisee.
- **Unnamed franchise** - Franchise keeps increasing rebates and fees earned from vendors - this is not disclosed in the disclosure document and the document does not limit these requirements. These franchise practices negate the benefit of group purchasing power, and the franchisee in fact pays higher fees than what's available on the general market.
- **Unnamed franchise** - Franchisors implement unreasonable and irrelevant requirements that hurt franchisees, like requiring answering machines and brand refreshes.



New Jersey

- **Honor Yoga** - Believes that the 2020 FDD given by Honor Yoga contained inaccurate FPR information in Item 19. Franchisee has no recourse to get audited information and has to trust what's in the FDD. There should be a requirement to provide this information and have it be audited.
- **Unnamed franchise** - Franchisee submitted an additional separate complaint that the FTC complaint form is not set up for franchisees to file about problems.
- **Massage Envy** - Comment from Massage Envy franchisee who owned three locations but is down to one. Franchisee decided to sell units because business had changed and impacted profitability. Believes that FDDs need to be reformed - information on profitability in ME FDD was inflated due to liabilities for prepayment of services. ME implemented new business policies, vendor requirements, technology systems, marketing programs, product purchase requirements, and human resource requirements that were not disclosed in the FDD and led to a decrease in profits. Burden now lies on franchisees to run the business model. The FDD language prevents franchisees from joining in collective legal actions and requires individual claim filings.
- **Unnamed franchise** - Franchisees need help to survive and need Congress to regulate franchisors.

New York

- **Experimax** - Highlights investments in Experimax of nearly \$500,000 in order to stay afloat. Argues that company provided false revenue projects so that franchisee could secure SBA-backed loans. As the number one store in the company, they estimate a 30% profit shortfall compared to the revenue projections for the SBA-backed loans. Accuses Experimax of deceitful collateral models, conspiracy to cover up a lack of distribution channels, conspiracy to provide false revenue projections, breach of territory, illegal marketing, trademark infringement, failure to retain support staff, and high closure rate. The franchisee family now receives government assistance with no path forward with company.
- **Unnamed franchise** - Requests the FTC update the Franchise Rule Compliance Guide to account for changes in technology and trends; FDD should be simplified and specific, accurate, in plain language and disclosed info should be properly placed and timed; tables and data visualization should be meaningful; FTC should test effects of disclosure; FTC should identify and consider costs and benefits of disclosure requirements. FTC should clarify FDD requirements.
- **Unnamed franchise** - Franchisees need more input with franchisors. Advisory board does not represent franchisees. More transparency is also needed.
- **Unnamed franchise** - FTC needs to examine the "loophole" in franchise agreements that gives franchisors a wide latitude in imposing new requirements. Financial conflicts of interest exist because franchise corporations receive compensation from suppliers and vendors. FTC should require specific disclosure,



such as the amount of compensation that franchise corporations receive and the identity of the suppliers/vendors.

- **Comment from franchise attorney** - Allow for audio and video in the FDD, create a cover page, create an FDD database, include supplemental disclosure letters, mandatory FPRs, include NASAA's recommended changes to the Franchise Rule, clarify the purpose of Item 19, and include clarifications on disclosures and acknowledgements outside the FDD.
- **Comment from practicing franchise attorney** - who thinks requiring financial performance representation would be a burden on franchisors; summary of an FDD would not be good because it would deter reading the whole FDD; and requiring that the franchisor not use any disclaimers in the FDD is not practical.

North Carolina

- **Massage Envy** - Franchisee notes that the FDD document is complicated and does not disclose information. Required vendors for purchasing supplies. No group purchasing power. ME also allows investor groups to have the right of first refusal when franchises are for sale, rather than allowing franchisees to choose whom to resell to.
- **Unnamed franchise** - Franchisee fees increase every year while franchisors fail to bring in business and charge hefty marketing fees. Requiring purchasing from certain vendors is another way for franchise corporations to generate profit.

Oklahoma

- **Unnamed franchise** - Argues that the Franchise Rule should reform Termination and Release Agreements and make it unlawful for franchisors to file SLAPP lawsuits against franchisees. Believes that the 2007 Franchise Rule does not address many aspects of what is in FDDs.

Pennsylvania

- **Experimax** - Franchisee who says that they lost over \$250,000 and that all the information franchisee received was fabricated. Charged for a moldy \$54k furniture package, a \$30k inventory package of junk, and a \$10k name change. Lawsuit by Apple was not disclosed and none of the services in the FDD were provided. Experimax tried to make franchisee sell the store, but franchisee closed store. Wants Experimax to be prosecuted and calls it a fraudulent business.
- **Subway** - Owns three Subway franchises in PA with a total staff of 15. Highlights difficulties with local inspectors who rule things out of compliance with arbitrary requirements. Franchisor required franchisee to purchase certain machines. Discusses how the \$5 footlong promotion is not profitable. Corporate never shares true profits. Franchisee was asked to invest in programs/remodels with no proven



ROI or business model. Franchisee discusses changes to the operations manual, required vendor purchases, and a marketing fund with no transparency.

Tennessee

- **Dental Fix** - Alleges Dental Fix is a sham that scammed franchisee out of \$50,000. Accuses Dental Fix of false advertising.
- **Mobility City** - Franchisee highlights changes to the operations manual that impact profitability and notes difficulties with the marketing fund.

Texas

- **Unnamed franchise** - Franchisors abuse the marketing fund to highlight the parent company instead of specific brands. Brands change requirements and add new fees and include vendor requirements that are more expensive. Franchisors aren't held accountable for the way they spend their marketing funds.
- **Unnamed franchise** - Believes there is an increasing imbalance between franchisor and franchisee. Over years, the agreement has been modified and is now so heavy handed that the franchisee is willing to walk away from business. Relationship is one sided in favor of the franchisor, and federal government needs to intervene.
- **Comment from franchise attorney** - Opposes mandatory FPR requirements, provide greater clarity and flexibility on explanations in the FDD, oppose efforts to abolish questionnaires, and encourage the use of technology for reading an FDD.
- **Tutor Doctor** - FDD does not include clear standards for franchisors. For example, Tutor Doctor does not have a good customer relationship management system. Brand marketing fund is also not reported out on and is not held accountable.
- **Which Wich Superior Sandwiches** - Owns one franchise with a staff of 12 - down from 15 franchises with a staff of more than 200. Franchisee was given franchise info that wasn't included in the FDD and was prevented from using that data to make a decision. Franchisee was asked to make investments in programs and remodels that weren't disclosed in the FDD. Changes to the operations manual impact profit, and franchise corporation has required increased rebates and/or fees from vendors that were not disclosed. Franchisor collects marketing fees but does not use funds for marketing.

Utah

- **Batteries Plus Bulbs** - Owns two Batteries Plus Bulbs stores in Utah with six full-time and two part-time employees. Since opening, franchisor has purchased corporate locations with no disclosure on profitability. Franchisor has required store opening hours that are not disclosed in the FDD. Franchisee fears being bought out a low price and wants the disclosure to include discussion of the franchisor's



strategy and tactics, especially with corporate-owned stores and policies regarding expansion/contraction.

- **Massage Envy** - Highlights required vendors for purchasing products. Believes franchisor is seeking to drive down Earnings Before Interest, Taxes, Depreciation and Amortization in order to allow for other private equity groups to buy out franchises.
- **Unnamed franchise** - Argues that rules are not properly enforced and that franchisee has little chance of being able to hold their own legally.

Virginia

- **Dental Fix** - Former Dental Fix franchisee was influenced to invest after a ride along with a franchisee that turned out to include exaggerated claims by a pushy sales person. Franchisee discusses meeting with an SBA lender who told him to "inflate the value of his home" to get more funds. Highlights insufficient training program that cost \$15,000. After signing the franchise agreement, he ran out of money after one year and is currently stuck paying off the SBA loan. His credit score plummeted from 800 to 600, he lost 60% of retirement account, and he has marriage problems and depression. He can't afford to go to the doctor and is worried about paying for his daughter's education. Through work with a fellow franchisee in Virginia, he got a small settlement, but still regrets being involved. Hopes to have SBA debt discharged.
- **Dental Fix** – Spouse of franchisee who owned a Dental Fix in 2017. Highlights that royalties and fees were expensive. Franchisor does not support owners.
- **Experimax** – Former Experimax owner who is filing for bankruptcy. Experimax's parent company (JFG) did not disclose legal problems, used false numbers to obtain an SBA loan, employed misleading tactics to get an equipment lease, did not have adequate business systems, allowed for territory competitions, levied expensive marketing and royalty fees, incurred high store closure rate. Highlights that the store failed to make a profit despite 50-60% margins and poor initial inventory.
- **Massage Envy** - Writing on behalf of an LLC that owns seven Massage Envy locations in Virginia with a staff of 190 employees. Highlights that the FDD does not disclose information on offers and purchases. Franchise corporation requires purchases from specific vendors that are more expensive than at market, requires purchase of liability insurance that is more expensive, and has failed to disclose criminal and civil liability incurred by Massage Envy. No clear use of marketing fund or disclosure on how funds are spent. Franchisee encourages FTC to correct deficiencies in the FDD, require disclosure, and generally improve the franchise system.
- **Unnamed Franchise** - Calls for support from the government to oversee franchisors and discusses how digital points as currency are detrimental.
- **Comment from franchise attorney** - Believes FTC should not add prohibitions or sanction practices that prohibit franchisors from providing accurate and truthful



information. Does not support banning merger clauses, believes questionnaires are accurate and widely available.

Washington

- **Dental Fix** - Franchisee is currently considering bankruptcy. Calls the company a well-crafted scam with subpar training and false claims about the rate of business. Company misleads on marketing and pits franchisees against each other. Franchisee took on lots of debt, had to sell house, and has \$40k in credit card debt.
- **Comment from franchise lawyer** - Requests mandating financial performance data. Notes problems with the FDD and disclaimers. Believes old Franchise Rule has failed franchisees and needs serious reforms.
- **UPS** - Alleges that franchisors make decisions that impact franchisees negatively. Include requiring remodels that do not have a proven business case. Prohibiting UPS stores from using DHL for international shipments negatively impacted franchisees. Franchisees want to sell but required remodels make it difficult.

Wisconsin

- **Experimax** - Experimax needs to be examined and general practices need to be examined. The franchisee was told lies and forced to use someone to create business plan and fudge numbers for an SBA loan approval. Franchisee was promised all kinds of help in the FDD and a well-priced supply chain, but did not receive that.
- **Unnamed franchise** - FDD does not prohibit franchisor from making policy changes that impact franchisee. Franchisor can do whatever it wants at franchisee's expense, such as promotions. This benefits franchisor's revenue while hurting franchisees.

National Organization or State Not Provided by Submitter

- **CBD American Shaman** - Need tighter controls over franchisees and need protection against franchisees that have an online presence and can poach customers.
- **Subway** - Subway is offering cheaper sandwiches during COVID, but franchisee has to make up the difference. Makes franchisee use different catering plate form that adds additional costs to franchisee.
- **7-Eleven** - Highlights risks with 7-Eleven and difficulties with financial projection disclosures. Notes instances of unfair and opportunistic behavior. Discusses undisclosed risks (with gasoline sales), declining gross margin, minimum wage increases, focus on costly fresh foods and hot foods, cost of goods, equipment



maintenance, poor disclosures, and specific instances of poor behavior by 7-Eleven corporate.

- **Dental Fix** - Franchisee invested all of his life savings into Dental Fix, and he highlights that most information available at time of purchase turned out to be untrue. Contends that the franchise has a high rate of failure - company was found to be fraudulent in Virginia after a lawsuit.
- **Discovery Point Franchising** - Says Discovery Point Franchising sells real estate at inflated, unsustainable prices with SBA loan guarantees. Colludes with banks and provides illegal profit estimates. Franchise sells centers and equipment under different names. FDD includes fraudulent cash flow estimates and did not disclose corporate-owned centers. FDD should list all closed locations and publish yearly statistics over the past five years. Franchisor manipulates the loan amount and equipment is sold at an inflated price. After franchises fail, taxpayers bail out the bank, and the franchisor profits from the loan. Discusses the churning of centers.
- **Massage Envy** - Owned a Massage Envy for eight years with 25 employees. Highlights changes to the disclosure document for new programs with no verified business model or proven ROI. Financials in FDD were misleading, and franchisor relies on revenue from required vendors that charge more for products than the open market.
- **Unnamed Franchise** - Owns an equipment repair business and had to make changes in order to see profitability. Main problem is the franchisor has more freedom than franchisee, including creating a competing company and requiring franchisees to purchase goods from certain sources. It's impossible to get out of an FDD, and franchisors have a leg up.
- **Service Employees International Union (SEIU)/Change to Win** - Highlights five franchisor practices (incomplete or misleading financial performance representations, significant capital investments, retaliation against franchisees that join associations, unfair termination or nonrenewal of franchise agreements, and arbitrary denial of transfer requests) as problematic. Submits contractual research and an update on franchise issues that illustrate how problems related to the model have persisted or worsened.
- **7-Eleven** - Please look into 7-11 as a franchisor. They have predatory policies, and franchisees have no way of getting relief.
- **Unnamed franchise** - Argues that most buyers don't understand the FDD and believes most FDDs are accurate. Has instituted guardrails to protect brokers from fraudulent claims. Encourage buyers to seek legal counsel and explain the business. Argues that the marketplace is fixing Item 19 and correcting itself.
- **Unnamed franchise** - Franchise contracts lock franchisees in for long terms and include non-compete clauses. Contracts favor franchisors and lack real protections for franchisees. Franchisors aren't interested in the profitability of the businesses that franchisees own and offer no support or procedures, forcing franchisees to walk away and lose money.
- **Unnamed franchise** - Says franchisor controls all aspects of the business even though franchisee invests. Franchisee is in the hotel business, so pays a



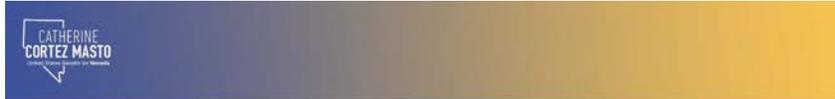
commission to websites on top of royalty fees. Evaluation and brand requirements don't make sense.

- **Unnamed franchise** - Need additional rules and laws to protect franchisees from corporations. Franchisor finds loopholes and takes percentages in retail. Also franchisor requires use of certain insurance and gets a kickback on that. Franchisee was promised a new computer/software system that doesn't work. Franchisor has forced franchisee to promote giveaways, free vouchers, and holiday offers that come out of profits.
- **Unnamed franchise** - Item 8 and Item 19 need to be changed to help franchisees. Item 8 does not disclose enough information about rebates to vendors - requests disclosure on markups of products. Asks for mandatory disclosure of FPR. Franchise Rule should prohibit franchisors from using disclaimers and questionnaires to avoid liability.
- **Unnamed franchise** - Need adequate resources to oversee and enforce the Franchise rule. Request a disclaimer in FDD that states that any conflicts/changes/additions to policies disclosures or other procedures outside the FDD are null and void. Recommends that FTC eliminate pre-dispute binding arbitration clauses, make the FDD be legally binding regardless of change in ownership, prohibit disclosure, obligations, or earnings outside of the FDD, require documentation of financial disclosures, earnings, investment requirements and include mandated disclosures (legal, financial, item 20 disclosures and general improvements) in FDD.
- **Fair Franchising Initiative (FFI)** - Current structure of FDD coupled with lack of regulation and enforcement hurts small businesses and generates profit for franchisors and Wall Street. The current system puts additional risk on franchisor. Franchisors use questionnaires and disclaimers to avoid responsibility and protect themselves from liability for false claims. Franchisors make changes to Operations Manuals that impact franchisees and limit profits.
- **International Franchise Association** - Supports the Franchise Rule in its current form. FPRs should not be mandatory and should not require executive summaries, and questionnaires and integration clauses should not be banned.
- **Asian American Hotel Owners Association** - Supports improvements to Item 19, reining in the use of disclaimers, and changing the format of the FDD that includes mandatory FPR and other information.
- **American Association of Franchisees & Dealers** - FTC has the authority to reform the Franchise Rule, reform financial performance representations to include all material financial impacts, adjust the force of liability waivers, and impose stronger enforcement of the FTC rule with Article 5 of the FTC Act. Argues that the Franchise Rule is not adequate as is.
- **Independent Association of Franchisees** - Highlights examples of abuse by franchisors and supports changes to the Franchise Rule that include strong consumer protections.
- **Oxford Learning** - Says FTC backing implies that FTC reviews and validate material in FDD when that is untrue. Franchisors are able to hide misleading claims.



FTC must require franchisors to include documents supporting material claims, such as patents, lawsuit judgements, education certification/diplomas/degree confirmation of company executives, income statement and balance sheets filed with the IRS and SEC. FTC should also require franchisors to include consolidated income statement of franchises and franchisees that is updated annually and to provide response to complaints filed.

- **Seniors Helping Seniors** - Seniors Helping Seniors franchisee with 50 employees. Marketing fund has no accountability and has not benefited any franchisee. National Promotional Fund is also not helpful, and there is no verification that it benefits the franchisees. Impossible for franchisees to hire legal representation.
- **Seniors Helping Seniors** - Seniors Helping Seniors implemented an additional fee for the Regional Advertising Fund, which has no reporting on how it is used on its finances. FDD notes that the option to charge a fee is possible, but there's no disclosure on how the funds are used. Franchisee wants more disclosure and reporting on how the fund is used.



XI. Appendix II: Letters to/from Small Business Administration

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United States Senate

COMMITTEE
FINANCE
BANKING, HOUSING, AND
URBAN AFFAIRS
ENERGY AND NATURAL RESOURCES
INDIAN AFFAIRS

May 21, 2019

Mr. Chris Pilikerton
Acting Administrator
U.S. Small Business Administration
409 3rd Street, SW
Washington, DC 20416

Dear Acting Administrator Pilikerton:

I write to request information regarding Small Business Administration (SBA) guaranteed loans to four franchisees. In recent months, my staff have heard about problems with Complete Nutrition, Dickey's Barbecue, Experimac and Subway from franchisee owners who have SBA-guaranteed loans and are having trouble with the franchisor. These problems reported by Nevada business owners are similar to that of other franchisees across the nation:

- Complete Nutrition. Franchisees with SBA-guaranteed loans told us that Complete Nutrition had made it very difficult for them to be profitable by raising the price they paid for goods, restricting access to certain products to earn higher franchise payments, prohibiting internet advertising and harvesting customers' data from the store and then marketing to the customer directly via email offering discounts that the franchisee could not match and taking away other services from franchisees that were providing them revenue. In March, Complete Nutrition told its franchisees it would no longer be a franchise and the individual stores would become independent. The franchisees were also required to make a payment to become independent. In April of this year, Complete Nutrition eliminated franchisees' access to the point-of-sale system, removed franchisees' locations from its website and sent an email to the customers of the individual stores telling them that their stores had been sold and that customers should order online. A few days later, Complete Nutrition sent an apology email to all the customers of its stores saying the email was sent in error. Complete Nutrition leadership has not responded to numerous requests for information from my office. From our research, it appears as many as 66 Complete Nutrition franchise stores which provide nutrition, health supplements, and other related beauty products have SBA loans. Some data shows at least 12% percent of the loans have been charged off.



- Dickey's Barbecue. Press reports find that Dickey's Barbecue franchises are closing at an alarming rate, including two in my state over the past few years.¹ According to Dickey's Barbecue Franchise Disclosure Document (FDD) dated September 4, 2018, for the fiscal year ended May 1, 2018, the brand opened 72 new franchised units, but had 89 terminations and 24 ceased operations, for a net store loss of 41 units.² They ended the year with 521 units. An additional 44 units transferred to new owners. The previous year showed 88 units opened, 70 ceased operations, and 67 transfers. It appears that some of the loan failures may be due to Dickey's Barbecue providing misleading and inaccurate information to potential franchisees, resulting in failed businesses and bankrupt owners.³ It appears Dickey's Barbecue was telling franchisees to expect revenue of up to \$80,000 per month but stores earned much less than that.⁴ Last year, at my request, your staff provided default data to my office that showed taxpayer-guaranteed loans to Dickey's Barbecue franchisees failing at a higher rate than is typical for fast-casual restaurants. It appears that a change in ownership at Dickey's Barbecue has dramatically raised costs for the franchisee.
- Experimac. Between January 2010 and September 2018, SBA recorded 63 loans to Experimac franchisees. A number of these franchisees feel the estimated revenue provided by Experimac was inaccurate and that they have never earned the revenue reported as typical. Experimac required unusually high initial payments of \$49,500 per franchisee. Experimac also required franchisees spend \$130,000 to design the store and buy the supplies. SBA guaranteed 63 loans to Experimac franchisees, of which 86% were made by Celtic Bank. Celtic Bank quickly sold them to investors. To date, at least 23% of these loans have failed. All the charged off loans, and nearly all the loans (54 loans or 86% of all loans) were financed by Celtic Bank Corporation, based out of Salt Lake City, Utah. In addition, Experimac was sued by Apple for patent violations, i.e. "Mac" without telling franchisees of the lawsuit threat.
- Subway. Subway franchisees across the nation are struggling to survive with expensive promotional offers and corporate decisions that undermine the franchisees' survival. A recent story noted that nearly 3% of SBA guaranteed loans for Subway franchisees have

¹ Maze, Jonathan. "Dickey's Barbecue Pit Closes 113 Units." September 14, 2018. *Restaurant Business*. Available at: <https://www.restaurantbusinessonline.com/financing/dickeys-barbecue-closes-113-units-franchisees-bolt>

² Dickey's Barbecue Restaurants, Inc. (2018). "Franchise Disclosure Document (Rep. No. 620051)." *Wisconsin Department of Financial Institutions*. Accessed May 20, 2019. Available at: <https://www.wdfi.org/apps/FranchiseSearch/details.aspx?id=620051&hash=1542075382&search=external&type=GENERAL>

³ Miller, Keith. "Can Dickey's BBQ Franchise Owners Survive? Franchisees Claim They Received Misleading Numbers." *Blue MauMau*. October 1, 2018. Available at: <https://www.bluemau.com/blog/2018/10/01/can-dickeys-bbq-franchise-owners-survive-franchisees-claim-they-received-misleading>

⁴ *Ibid.*



been charged off. Subway is accused by its franchisees of using minor infractions to steal the stores from owners through a rigged arbitration system.⁵

I would like to inform my constituents of the resources SBA can provide to help them avoid default. I would also like to ensure other franchisees do not receive government-guaranteed loans for franchisees with a history of complaints about unfair and deceptive practices. Therefore, I request the following information:

1. How is the SBA working with franchisees with SBA loans when a franchisee runs into trouble?
 - a. Specifically, when the SBA notices high rates of defaults in a franchise, what action does your staff take to prevent loan failures?
 - b. If there is a major change in an agreement, like those that occurred with Complete Nutrition, Subway or Dickey's Barbecue, what recourse does the SBA have to prevent loan failures?
 - c. How does SBA review ownership changes and what can SBA do when such changes have the potential to harm the revenue of franchisees with existing SBA loans?
 - d. Regarding Complete Nutrition, what can SBA do when a franchisor terminates the franchise agreement entirely? Does Complete Nutrition have affiliated brands seeking SBA-guaranteed loans? If so, what are the other brands?
 - e. Are there examples of other SBA-guaranteed franchisors making similar decisions as the one Complete Nutrition made to stop being a franchisee? If so, how were the franchisees compensated? Did the franchisor make payments on outstanding loans of the franchisees?
 - f. Can the SBA exclude a brand if there are significant problems with one of the franchises in its portfolio? Has the SBA stopped loan guarantees to one brand because of problems in a franchise within its portfolio? If so, which franchise brands and franchise owners and when?
2. How many total loans did SBA make to the four mentioned franchises over the past six years -- 2013-2019? Please break out the loans by year and state.
3. How many of the four franchises have loans that defaulted? How soon after the loan closed were those loans charged off? Please break out this information by year and state.
4. How many of the four franchises mentioned are behind in their loans but are not listed as defaulting yet? How soon after the loan closed were those loans charged off? Please break out this information by year and state.

⁵ Kosman, Josh. "Subway's arbitration for minor infractions is out of control: franchisees." New York Post. May 5, 2019. Retrieved from: <https://nypost.com/2019/05/05/subways-arbitration-for-minor-infractions-is-out-of-control-franchisees/>



5. What information on revenue, defaults and store closings does the SBA require franchisors to provide to franchisees seeking SBA-guaranteed financing? Is that information provided within the Financial Disclosure Document?

According to a 2018 report from the International Franchise Association (IFA), Nevada is predicted to have the fastest franchise growth in the nation.⁵ While many of my constituents are successful franchise owners, I am troubled by increasing complaints from entrepreneurs about unfair practices that are causing them financial difficulties. Please respond to this request by June 21, 2019. For more information please contact Carol Wayman on my staff at 202.224.3542 or Carol_Wayman@cortezmasto.senate.gov.

Sincerely,

A handwritten signature in blue ink that reads "Catherine Cortez Masto".

Catherine Cortez Masto
United States Senator

CC: United States Senate Small Business Committee Chairman, the Honorable Marco Rubio
United States Senate Small Business Committee Ranking Member, the Honorable Ben Cardin

⁵IHS Market Economics, "Franchise Business Economic Outlook for 2018." *International Franchise Association*, January 2018. Available at: https://franchiseeconomy.com/files/Franchise_Business_Outlook_Jan_2018.pdf



U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, DC 20416

June 17, 2019

The Honorable Catherine Cortez Masto
United States Senate
516 Hart Senate Office Building
Washington, DC 20510

Dear Senator Cortez Masto,

Thank you for your letter of May 21, 2019, to Acting Administrator Pilkerton regarding U.S. Small Business Administration (SBA) guaranteed loans to four franchises: Complete Nutrition, Dickey's Barbeque, Experimac, and Subway. Acting Administrator Pilkerton has asked me to respond on his behalf.

As you may be aware, while SBA is an important resource for financial assistance for would-be small business owners without access to credit on reasonable terms, the Federal Trade Commission (FTC) is the key agency for the American public to obtain and report information about various business entities, including franchises. Because it appears that the concerns you raised in your letter fall within the area of responsibility of the FTC, we have referred your letter to their Bureau of Consumer Protection for further review /action. As the federal agency with responsibility for protecting consumers by stopping unfair, deceptive or fraudulent practices in the marketplace, the FTC conducts investigations, sues companies and people that violate the law, develops rules to ensure a vibrant marketplace, and educates consumers and businesses about their rights and responsibilities.

In fact, the FTC has a special responsibility when it comes to franchise systems. The FTC requires franchisors to update their Franchise Disclosure Document (FDD) each year, which includes statements to inform a prospective franchisee about historical representations (how much existing franchisees have earned in the past) or projections (how much an individual prospective franchisee is likely to earn in the future). Although franchisors may decide how they wish to disclose financial performance of the brand (provided that disclosure meets FTC requirements), the FTC prohibits a franchisor from making a financial representation that is not true or unsubstantiated.¹ Complaints regarding specific franchisors are normally handled by the FTC under federal law or through state agencies under state franchise laws. The FTC has resources available to help members of the public spot scams involving businesses, including franchise businesses. The FTC also provides a link on their website for the public to file complaints. Complaints are shared with law enforcement partners

¹ For more information about the FTC's requirements for franchisors, including required disclosures by franchisors, see <https://www.ftc.gov/enforcement/rules/rulemaking-regulatory-reform-proceedings/franchise-rule>.



and are used to investigate fraud and eliminate unfair business practices. The FTC also releases an annual report that provides information about the number and type of complaints they receive.

SBA's engagement in franchise businesses includes its guarantees of loans that are made by its lending partners to small businesses that operate under an agreement with a franchisor (a franchisee). A relatively small percentage of SBA's guaranteed loan portfolio, fifteen percent, is made up of loans to businesses that operate under franchise agreements. Under SBA's current franchise review process, SBA reviews franchise brands only to determine if the brand is eligible for SBA financial assistance based on SBA size standards (including determining if there is affiliation between the franchisor and its franchisees) and type of business activity. SBA does not endorse or recommend franchise brands. Rather, SBA lists those brands found to be eligible under size and affiliation standards on a publicly available directory so that before making an SBA loan to an applicant, SBA Lenders may rely on the directory for the franchise brand's eligibility for SBA financial assistance. However, it is important to note that those lenders are responsible for analyzing and making a determination as to the creditworthiness of the brand and of the small business Applicant (franchisee).

SBA's monitoring of ongoing franchise loans is generally limited to the performance of participating lenders through its Office of Credit Risk Management (OCRM). OCRM conducts monthly as well as a semiannual performance analysis of the loan portfolio generally, and with segmentation, including loans made to franchisees. OCRM also reviews lender performance and provides individual lender performance data to SBA Lenders through a lender portal. SBA Lenders are expected to review the portal on a regular basis, which enables the Lender to identify its loan portfolio performance down to the individual loan level. OCRM will engage SBA Lenders when identifying trends with respect to loans to borrowers operating under a franchise agreement. The Lender would be expected to take action to mitigate risk. If an SBA Lender were to determine that the performance of a franchise brand did not meet its credit parameters, the Lender would curtail lending to that franchise to minimize its risk of loss. If an SBA Lender were to become aware of any information indicating that fraud may have occurred in connection with an SBA loan, the Lender would be required to report the suspected fraud to the SBA Office of Inspector General. 13 CFR 120.197.

When a franchisee with an SBA loan experiences financial difficulty, the SBA Lender would typically work with the small business to attempt to address the issues. In addition, SBA's resource partners, such as Small Business Development Centers, SCORE, Women's Business Centers and Veterans Business Outreach Centers, are available to work with small businesses experiencing difficulties.

Below is SBA loan approval and charge-off data for the last ten years (2019 information is year-to-date) on the four franchises identified in your letter, both nationally and for the State of Nevada. (Please note that SBA loans to Experimac did not predate 2016.

1. Experimac (Fiscal Years 2016-2019)
 - Number of SBA loans approved: 77 nationally, 2 in Nevada
 - Number of SBA loans charged off: 23 nationally, 1 in Nevada
2. Complete Nutrition (Fiscal Years 2009-2019)



¹ Generally, charge-off occurs when all reasonable efforts to achieve recovery on the loan have been exhausted or the loan balance is deemed legally uncollectible.

Number of SBA loans approved: 67 nationally, 2 in Nevada

Number of SBA loans charged off: 8 nationally, 0 in Nevada

3. Dickey's BBQ (Fiscal Years 2009-2019)

Number of SBA loans approved: 246 nationally, 4 in Nevada

Number of SBA loans charged off: 41 nationally, 0 in Nevada

4. Subway (Fiscal Years 2009-2019)

Number of SBA loans approved: 1,551 nationally, 10 in Nevada

Number of SBA loans charged off: 184 nationally, 3 in Nevada

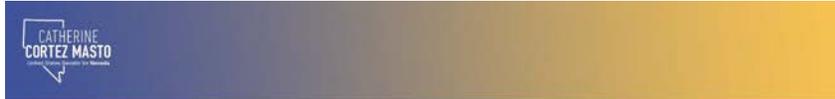
We encourage Congressional offices to reach out to the FTC to learn more about franchise issues as well as their state Bureau of Consumer Protection for relevant information on franchisors operating in their states.

We appreciate your support of SBA and the Nevada small business community.

Sincerely,

Dianna L. Seaborn
Director
Office of Financial Assistance

cc: United States Senate Small Business Committee Chairman, The Honorable Marco Rubio
United States Senate Small Business Committee Ranking Member, The Honorable Ben Card



CATHERINE CORTEZ MASTO
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United States Senate

COMMITTEES
FINANCE
BANKING, HOUSING, AND
URBAN AFFAIRS
ENERGY AND NATURAL RESOURCES
INDIAN AFFAIRS

August 1, 2019

Ms. Dianna L. Seaborn
Director
Office of Financial Assistance
Small Business Administration

Dear Administrator:

We write regarding your June 17, 2019 letter responding to Senator Cortez Masto's request for information about Small Business Administration (SBA)-guaranteed loans to four franchises. Your response did not fully address the questions, nor did you confirm whether the SBA is following its own protocols when guaranteeing loans to entrepreneurs purchasing a franchise.

In your response, you reported that the SBA guaranteed 256 loans to entrepreneurs from four franchise brands who were later unable to repay them; hundreds of entrepreneurs lost their collateral, their savings, may have lost their home, and even forced to declare bankruptcy after buying one of these four franchises. Your letter noted that nearly one in three loans to Experimac franchises failed within three years of operation.¹

Your letter provided information on loan failure rates in Nevada, but failed to provide the information about failure rates in other states as requested. Your response also failed to provide the information about default rates by year, as was requested. Without charge-off rates by year, it is impossible to see if defaults are historic, recent or chronic.

Your letter implies that once a franchisee has signed a contract with a franchise, then every loan that meets "SBA size standards and types of business activities" is eligible as long as a lender wishes to make the loan. However, the SBA's own Standard Operating Procedure -- Lender and Development Company Loan Programs, SOP 50 10 5(J)² -- clearly requires the SBA ensure that the lender does a financial analysis to verify the loan is likely to be repaid:

1. *Thus, if the Lender's financial analysis demonstrates that the Applicant lacks reasonable assurance of repayment in a timely manner from the cash flow of the business, the loan*

¹ Seaborn, Dianna. Small Business Administration Letter to Senator Catherine Cortez Masto. June 17, 2019.

² Small Business Administration. "Lender and Development Company Loan Programs. Standard Operating Procedure, SOP 50 10 5(J)." January 1, 2018. Retrieved from:
https://www.sba.gov/sites/default/files/2017-10/SOP%2050%2010%205%28J%29_FINAL_.pdf



request must be declined, regardless of the collateral available or outside sources of cash.
Page 170. Underlining in original.

2. *"a) Lender's Credit Analysis: Lender's credit memorandum and analysis must address the Applicant's ability and likelihood to repay the loan from the cash flow of the business and past performance by documenting the following:*
 - [...] ii. Financial analysis of repayment ability:*
 - (a) For existing businesses based on the three most recent years of historical financial information (tax returns or balance sheet with debt schedule and income statement) plus an interim financial statement. (13 CFR § 120.191) SOP 50 10 5(J) Subpart B. Page 172*
 - (b) For new businesses, detailed projections, including the supporting assumptions which reflect positive cash flow within 2 years will be required.*
 - (c) The financial analysis for all Applicants must address the following as applicable:*
 - (i) Historical cash flow for existing businesses, that demonstrates total debt service coverage after the SBA loan; if the historic cash flow does not show sufficient debt service coverage, Lender must obtain from the Applicant and analyze two years of detailed projections including the supporting assumptions;*
 - (ii) Calculation of operating cash flow (OCF) defined as earnings before interest, taxes, depreciation and amortization [...]*
 - (b) For new businesses, detailed projections, including the supporting assumptions which reflect positive cash flow within 2 years will be required." Page 171-172.*
3. *"Debt Service (DS) is defined as the future required principal and interest payments on all business debt inclusive of new SBA loan proceeds. The Applicant's debt service coverage ratio (OCF/DS) must be equal to or greater than 1.15 on a historical and/or projected cash flow basis and 1:1 on a global basis. To perform a complete analysis of debt service, it is important for a Lender to obtain a current debt schedule prepared by the Applicant, including any shareholder debt." Page 172.*
4. *"b) The Borrower and/or OC will maintain proper books and records, allow Lender and SBA access to these records, and furnish financial statements or reports annually or whenever requested by Lender;" Page 227.*

We request more information about SBA-guaranteed loans to these four franchises. We also request information that explains how the SBA provides oversight of lenders. Problems noted a few years ago continue to occur, including:

1. In a July 2011 report, the SBA Office of Inspector General (OIG) reported that SBA must enforce its requirements and ensure the bank receive and verify financial performance data



prior to making a loan.⁹ SBA's OIG found that a bank violated 7(a) loan program rules by disregarding relevant and available data, which indicated that the franchisees' revenue projections were unreasonable. Had the lender complied with SBA's requirements to use and assess the feasibility of realistic projections, 12 loans to Huntington Learning Center franchisees would have been declined. The OIG recommended that the SBA "[i]mprove the quality of franchise loan data by implementing a plan to ensure the completeness and accuracy of data pertaining to new franchise loans made in the future and correct existing incomplete loan records."¹⁰

2. A September 2013 Government Accountability Office (GAO) report concurred, finding that "franchisees noted difficulties meeting anticipated revenue estimates." GAO noted that franchisors' "limited access to information that would aid [franchisees] in business planning." According to GAO's analysis, "the first-year projected revenues on loan applications involving [a] loan agent or her employer were, on average, more than twice the amount of actual first-year revenue for 19 of the 24 franchisees reviewed." GAO noted that first-year revenue estimates are not necessarily available to potential franchisees in the franchise organization's financial disclosure document nor do federal regulations require franchise organizations to provide actual first-year average revenues for start-up businesses in their disclosure document. The GAO recommended that SBA improve its oversight of its loans portfolio, such as default status, number of loans, and loan agent information.¹¹

Please answer the following questions:

1. How is the SBA working with franchisees with SBA loans when a franchisee runs into trouble?
 - a. Specifically, when the SBA notices high rates of defaults in a brand, what action does your staff take to prevent loan failures?
 - b. If there is a major change in an agreement, such as changes that occurred with Complete Nutrition or Dickey's Barbecue, what recourse does the SBA have to prevent loan failures?
 - c. What can the SBA do when a franchisor, such as Complete Nutrition, terminates the franchise agreement entirely? Can the SBA require the franchisor make payments on outstanding loans of the franchisees? Has the SBA collected the guarantees paid out by SBA from any franchisor? Will the SBA seek recovery from the lender of all purchase amounts disbursed if the underlying financial information was inaccurate?

⁹ Office of Inspector General, U.S. Small Business Administration. "Banco Popular Did Not Adequately Assess Borrower Repayment Ability When Originating Huntington Learning Center Franchise Loans." Report Number: 11-16. July 13, 2011. Retrieved from: https://www.sba.gov/sites/default/files/oig/Audit%20Report%2011-16_0.pdf.

¹¹ GAO. "Review of 7(a) Guaranteed Loans to Select Franchisees." September, 2013. Retrieved at: <https://www.gao.gov/assets/660/667723.pdf>.



- d. Can the SBA exclude an owner of a troubled franchise brand who has other franchises if there are significant problems with one of the franchise brands in their portfolio?
 - e. Has the SBA stopped loan guarantees to one franchise because of problems in another franchise with the same ownership? If so, which franchise brands?
6. Please provide charge off loan data for all states¹¹, broken down by state, for Complete Nutrition, Experimac, Subway and Dickey's Barbecue. Please list the defaults for each franchise brand by state for all states.
 7. How many SBA backed loans to these four franchises are behind in their exempt status but are not yet listed as defaulting?
 8. Of the 256 charge offs to SBA-guaranteed loans to Complete Nutrition, Experimac, Subway and Dickey's Barbecue franchisees, how soon after the loan closed were those loans charged off? Please provide information for each franchise by how many loans defaulted within a year, two years, three years, etc. and by state for all states as appropriate.
 9. Were any of the agents associated with any of those franchise brands previously suspended from the SBA program for misconduct or another reason?
 10. Franchisors are not required to provide actual financial information in the Franchise Disclosure Document to franchisees. However, the SBA still requires lenders receive historic financial data. What information on revenue, default and store closings does the SBA require lenders receive from franchisors? Of that material, what is provided to the franchisees taking out the loan to buy the franchise?

¹¹ "States" is defined to include all 50 states, territories, and the District of Columbia.



Please respond to this request by September 9, 2019. For more information, please contact Carol Wayman at 202.224.3542 or at Carol.Wayman@cortezmastosenate.gov.

Sincerely,

A handwritten signature in blue ink that reads "Catherine Cortez Masto".

Catherine Cortez Masto
United States Senator

A handwritten signature in blue ink that reads "Tammy Baldwin".

Tammy Baldwin
United States Senator

CC: Senate Small Business Committee Chair Marco Rubio
Senate Small Business Committee Ranking Member Benjamin L. Cardin



U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, DC 20416

September 19, 2019

The Honorable Catherine Cortez Masto
United States Senate
516 Hart Senate Office Building
Washington, DC 20510

The Honorable Tammy Baldwin
United States Senate
709 Hart Senate Office Building
Washington, DC 20510

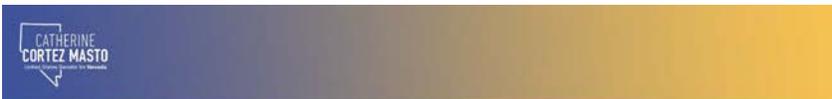
Dear Senators Cortez Masto and Baldwin:

Thank you for your follow up letter of August 1, 2019, regarding U.S. Small Business Administration (SBA) guaranteed loans to franchisees in four franchise systems: Complete Nutrition, Dickey's Barbeque, Experimac, and Subway.

Attached per your request is a data table that discloses, by fiscal year, the number and dollar amount of loans approved for each of the four franchise systems by state, as well as the charge off rate by units and dollars, and the SBA's pro-rata portion of the losses. Also attached are data tables which provide charge off loan data for all states, broken down by state, and how many loans defaulted within a year, two years, etc., as well as how many loans are current/non-current (but not yet in default).

You have asked about the prevention of loan failures by franchisees in SBA's guaranteed loan program. SBA financial assistance is designed to give small businesses that lack credit elsewhere an opportunity to start, build and grow their business. Unfortunately, not all SBA borrowers will succeed. The probability of success and risk of loan failure are assessed by the lender and the small business applicant prior to the lender making the loan. SBA provides lenders with detailed guidance on eligibility and underwriting standards in Standard Operating Procedures (SOP) 50 10, "Lender and Development Company Loan Programs." Lenders must consider, among other things, the creditworthiness of the applicant and the feasibility of the applicant's business plan. In accordance with SBA Loan Program Requirements, loans are not considered creditworthy unless the lender has determined up front that there is reasonable assurance of repayment from the operations of the small business.

Pursuant to the Federal Trade Commission's ("FTC") amended Franchise Rule, 16 CFR Part 436, franchise systems ("Franchisors") are required to disclose certain information to



prospective franchisees ("Franchisees") in the form of a Franchise Disclosure Document ("FDD") and Franchise Agreement prior to any payment by the Franchisee to the Franchisor. SBA requires lenders to obtain a copy of all documents that a Franchisor requires a Franchisee to sign in order to open and operate a franchise as part of the application for an SBA-guaranteed loan. When considering an application for an SBA-guaranteed loan, lenders are required to exercise the same level of prudence and care in extending credit that they do for their similarly-sized, non-SBA guaranteed commercial loans. Once a lender makes a loan to a Franchisee, SBA requires the lender to service the loan in a commercially reasonable and prudent manner. SBA provides additional written guidance through SOP 50 57 2, "7(a) Loan Servicing and Liquidation" in the event that certain servicing actions become necessary during the life of the loan. SBA will work with the lender and the small business, if necessary, to try to resolve any issues.

Should an SBA-guaranteed loan become seriously delinquent or classified in liquidation, SBA requires that lenders make a good faith effort to negotiate a workout plan on the loan, whenever feasible. Generally, a workout agreement restructures the material terms and conditions of the debtor's delinquent loan in order to: avoid the need for actions such as foreclosure or bankruptcy; enable the debtor to cure defaults and improve repayment ability; and enable the creditor to maximize recovery on the loan. SBA's prior written approval of a workout plan is not generally required.

In addition, SBA's resource partners, such as Small Business Development Centers, SCORE, Women's Business Centers and Veterans Business Outreach Centers, are available to support small businesses (including small franchisees), whether or not they seek financing, and particularly when experiencing operational issues.

You have also asked about situations where there are changes to a franchise agreement. After the initial review of an agreement and placement of a brand on the SBA Franchise Directory ("Directory"), SBA requires Franchisors to make an annual certification regarding any changes to the franchise agreement that might affect the eligibility (*i.e.*, size/control and nature of the business) of the franchise system for SBA financial assistance. Franchisors that use SBA's standard form of addendum are not required to provide an annual certification.

You also asked if SBA seeks recovery from the Franchisor in the event that a Franchisee defaults on a loan. SBA is not a party to the franchise agreement and, as a result, SBA has no contractual or other direct relationship with the Franchisor. Further, the Franchisor is not a guarantor of the loan. It is the responsibility of the lender to make and collect all loans for which they received an SBA guaranty. In accordance with SBA Loan Program Requirements, the lender must determine up front that there is reasonable assurance of repayment from the operations of the small business. In accordance with SBA Loan Program Requirements and prudent lending standards, the lender sets the terms and conditions of each loan and the loan is funded and collected in accordance with those terms and conditions.

In the event of default and liquidation, the lender must seek recovery based on the note terms from all sources identified and, with respect to 7(a) loans, must liquidate all business personal property collateral prior to requesting SBA to honor the guaranty. SBA reviews purchase requests and supporting documentation when presented to one of SBA's purchase centers



and determines if the loan met eligibility and credit requirements at the time of approval. Should the lender not have followed the Loan Program Requirements, SBA may be released from its liability to honor the guaranty and the lender bears the entire loss, if any.

As we indicated in our letter of June 17, 2019, SBA has created the Directory of all franchise and other brands reviewed by SBA that are eligible for SBA financial assistance. The Directory only includes business models that SBA determines are eligible under SBA's affiliation rules and other eligibility criteria. If SBA determines the franchise system or business model does not meet all of SBA's eligibility criteria, the brand will not be included on the Directory. Please note that "eligibility" criteria do not include repayment ability, which is an indicator of creditworthiness.

You have asked "[h]as the SBA stopped loan guarantees to one franchise because of problems in another franchise with the same ownership?" SBA has not stopped guaranteeing loans to franchisees of one franchise system because of problems in another franchise system with the same ownership.

Individuals and entities suspended, debarred, revoked, or otherwise excluded under the SBA or Government-wide debarment regulations are not permitted to conduct business with SBA, including participating in an SBA-guaranteed loan. Lenders are responsible for consulting the General Services Administration's System for Awards Management's (SAM) Excluded Parties List System (EPLS) or any successor system to determine if an employee or an Agent has been debarred, suspended or otherwise excluded by SBA or another Federal agency. There have been no Agent suspensions or debarments in connection with the subject franchise brands.

You have asked about the availability of financial data related to a franchise system. Pursuant to the FTC's amended Franchise Rule noted above, Franchisors may include representations about their financial performance in their FDDs, and if they do so, must follow the guidance in the FTC's Compliance Guide, specifically Item 19. (See, <https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-ruse-compliance-guide.pdf>.) The financial information provided in a brand's FDD, generally, does not include financial information for a specific location. Under all SBA loan programs, not just loans to a franchise brand, lenders are required by regulation (13 CFR § 120.150) and SOP (SOP 50 10 5(K)) to address in their credit analysis for each loan application the Applicant's ability and likelihood to repay the loan.

Lenders should follow their normal procedures in obtaining the required financial information when analyzing the credit for a loan to a franchise. This information may come from the FDD, the seller of the business, or the projections of the applicant. We do not require lenders or Franchisors to provide revenue, default or store closings information to SBA, nor do we provide such information to any franchisee.

The Office of Credit Risk Management ("OCRM") is responsible for oversight of all lenders participating in SBA loan programs. OCRM conducts regular review and examination of lenders and their respective loan portfolios to ensure compliance with SBA Loan Program Requirements. Lenders receive information regularly to identify any areas of concern, with



recommendations for corrective actions. SBA has no authority to review or examine Franchisors and only reviews the brand for affiliation and eligibility for SBA financial assistance and placement of the brand on the Directory.

We encourage Congressional offices to reach out to the FTC to learn more about franchise issues as well as their state Bureau of Consumer Protection for relevant information on Franchisors operating in their states.

We appreciate your continued support of SBA and the Nevada and Wisconsin small business community.

Sincerely,

Dianna L. Seaborn
Director
Office of Financial Assistance

CATHERINE CORTEZ MASTO
NEVADA

313 HART SENATE OFFICE BUILDING
WASHINGTON, DC 20510
(202) 224-3942
CortezMasto.Senate.Gov

United States Senate

COMMITTEE
FINANCE
BANKING, HOUSING, AND
URBAN AFFAIRS
ENERGY AND NATURAL RESOURCES
INDIAN AFFAIRS

April 13, 2021

The Honorable Isabel Casillas Guzman
Administrator
Small Business Administration
409 Third Street, SW, Suite 7900
Washington, DC 20416-2230

Dear Administrator Guzman:

I write to you today regarding my office's publication of a staff report entitled "Strategies to Improve the Franchise Model: Preventing Unfair and Deceptive Franchise Practices." This report raises concerns about the current state of some franchising business models and suggests solutions to improve outcomes for small business owners, workers, communities and taxpayers. In my discussions with franchisees, both in Nevada and across the nation, as well as recent press stories, it is clear that the federal government must do more to protect entrepreneurs from deceptive practices.

My report details specific improvements the Small Business Administration (SBA) can take within its administrative authority to help franchise business owners avoid deceptive practices. These include:

- Require revenue and store closure data for franchise owners receiving SBA-guaranteed loans;
- Prohibit franchise corporations from disclosing revenue data that is in direct conflict with the information contained in a disclosure document;
- Publish loan default data by franchise brand and cease guarantees for brands with high levels of defaults;
- Require that only franchises that include historic revenue data in its Financial Disclosure Document (FDD) are eligible for SBA guarantees on loans;
- Prohibit SBA guarantees on loans for franchises that include mandatory arbitration, prohibitions on associations or other unfair practices; and
- Establish a franchisee help line for franchise owners facing issues.

I have reached out to the SBA Office of Legislative Affairs for technical comments on legislation I plan to introduce this Congress that requires the SBA act to reduce defaults on franchise loans. These bills include protections recommended in the report, such as requiring the disclosure of financial performance data for all SBA-guaranteed loans, ensuring the SBA publish loan performance data for all franchise brands and preventing loans to franchise brands with high rates of default. In many cases, my legislation is not necessary; the SBA can implement these protections administratively.

LAS VEGAS
333 LAS VEGAS BOULEVARD SOUTH
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LAS VEGAS, NV 89101
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MOBILE OFFICE
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RENO
400 SOUTH VIRGINIA STREET
SUITE 907
RENO, NV 89501
(775) 686-5750
FAX: (775) 686-5757

Given the information and data in the report, I urge the SBA implement its recommendations and take action to enforces existing rules that require franchisors follow fair practices in order to receive loans backed by taxpayer funds. I look forward to meeting with you to discuss the report and what steps the SBA can take to protect franchisees from fraudulent and deceptive practices. Please respond to this letter no later than May 28, 2021. If you have any questions, contact my staff, Carol Wayman, at Carol_Wayman@cortezmasto.senate.gov or at 202-224-3150.

Sincerely,

A handwritten signature in blue ink that reads "Catherine Cortez Masto". The signature is fluid and cursive, with the first name "Catherine" being the most prominent.

Catherine Cortez Masto
United States Senator

United States Senate

WASHINGTON, DC 20510

March 1, 2022

The Honorable Isabel Casillas Guzman
Administrator
Small Business Administration
409 Third Street, SW, Suite 7900
Washington, DC 20416-2230

Dear Administrator Guzman:

We write to inquire if franchisees with Small Business Administration (SBA)-guaranteed loans may receive debt relief when their franchisors are cited for unfair or deceptive practices; does the SBA permit franchise borrowers whose brands were sanctioned to have the borrowers' outstanding debts forgiven?

In the past few years, some state regulatory agencies sanctioned some franchise brands for deceptive practices. In addition, some courts found some franchises liable for unfair or deceptive practices. The Federal Trade Commission and the Department of Justice filed suit against a specific brand as well last month. Some examples of court or regulatory actions pertaining to specific franchise brands include:

- The Federal Trade Commission and the Department of Justice filed a suit against the Burgerim franchise for deceptive practices and violations of the Franchise Rule.¹
- The State of California ordered Burgerim to pay nearly \$4 million in fines and refund the franchise fees paid by more than 1,500 people after finding that the company violated numerous state franchise regulations.² Washington and Maryland also revoked Burgerim's right to sell franchise registrations.³
- The Commonwealth of Virginia and Washington State settled claims with Dental Fix franchise, finding that the franchise made unclaimed statements of material fact, including misrepresentations of franchise revenue forecasts or omitted material facts in the offer and sale of franchises.⁴

¹ https://www.ftc.gov/system/files/documents/cases/2022.02.07_complaint_filed_002_0.pdf

² <https://dfpi.ca.gov/vsp-content/uploads/sites/337/2021/02/Citations-DR-Burgerim-Group-USA-Inc.pdf> and <https://www.restaurantbusinessonline.com/financing/state-california-orders-burgerim-refund-franchise-fees>

³ <https://www.restaurantdive.com/news/burgerim-drama-mounts-as-wa-md-revoke-franchise-registration/572232/>

⁴ <http://www.unhappyfranchisee.com/dental-fix-franchise-violations-va>
<https://dfi.wa.gov/documents/securities-orders/S-19-2776-20-CO01.pdf>

- In 2017, a Texas jury returned a unanimous verdict in favor of 52 qualifying Curves franchise owners, awarding them 80% of their net operating losses, totaling approximately \$1.5 million.⁵ Curves appealed the decision to the United States Court of Appeals for the Fifth Circuit. The parties ultimately settled while the case was on appeal.

Court decisions and regulatory actions that find violations of law or unfair practices should affect the SBA's process related to current and future loans. Please respond to these questions:

- After a finding of unfair or deceptive practices against a franchisor, does SBA relieve the franchisee borrower of the requirement to pay their loan? If not, why not?
- After a legal or regulatory decision of wrongdoing by a franchise, how does SBA investigate the loan process and lenders who made the initial loans to ensure SBA's standard operating protocol was followed?
- How would the SBA determine if the lender failed to do its due diligence to ensure that the loan was repayable by revenue from the franchise business per the standard operating protocol?⁶
- Please describe any investigations undertaken by the SBA into the decision-making process of lenders or brokers of franchise loans with high rates of default?⁷
- If the lender was aided by a franchise broker, does the SBA investigate the actions of that broker as it may relate to other franchises?
- When SBA experiences high rates of defaults for its guaranteed loans for specific franchise brands, what action does the SBA take?
 - For example, SBA stopped guaranteeing loans to Burgerim after complaints surfaced.⁸ However, at least 119 Burgerim franchisees had \$38 million in SBA

⁵ Amanda Smith-Teutsch. "Curves Franchisees File Suit over Collapse of Company." *Legal Newsline*, February 25, 2020. <https://legalnewsline.com/stories/525978652-curves-franchisees-file-suit-over-collapse-of-company>;

Anne Armstrong et al. v. Curves International, Inc. 6:15-cv-294-RP, (W.D. Tex. 2017); "Fortman Law Wins \$1.5 Million for CURVES Franchisees"; "Jury Awards Franchisees 80% Net Operating Losses." Blue Maumau, April 27, 2017.

⁶ Small Business Administration. "Lender and Development Company Loan Programs. Standard Operating Procedure. SOP 50 10 5(J)." January 1, 2018. Retrieved from: https://www.sba.gov/sites/default/files/2017-10/SOP%2050%2010%205%28J%29_FINAL_.pdf

⁷ Patrick Clark. "Franchise Loans Keep Blowing Up, and the Government Keeps Backing Them." Bloomberg, May 14, 2015. <https://www.bloomberg.com/news/articles/2015-05-14/franchise-loans-keep-blowing-up-and-the-government-keeps-backing-them>;

Josh Freedman. "Big Whopper Economics." *Washington Monthly*, March/April/May 2014. <https://washingtonmonthly.com/magazine/marchaprilmay-2014/big-whopper-economics/>.

⁸ Jonathan Maze. "The Burgerim Disaster." *Restaurant Business*, January 17, 2020. <https://www.restaurantbusinessonline.com/emerging-brands/burgerim-disaster>.

guaranteed loans. What relief was provided to Burgerim borrowers with outstanding SBA-guaranteed loans?

- Did SBA publish any guidance following problems with specific franchise brands with high rates of SBA defaults? If so, please share such guidance.
- What discussions has SBA staff had with the SBA Office of the Inspector General regarding high default rates for certain franchise brand loans?
- Has the SBA ever denied a guarantee to a lender for a loan to a franchise? If so, when, to which franchise brand and based on what criteria?
- Does the SBA share loan default information with the Federal Trade Commission to highlight problematic franchise performance?

Court and state government actions, along with concerns raised in Senator Cortez Masto's office's 2021 report, *Strategies to Improve the Franchise Model: Preventing Unfair and Deceptive Franchise Practices*,⁹ continue to demonstrate the need for greater disclosure of the risks of investing in certain franchise brands and increased SBA oversight over its guaranteed loans to franchise businesses.

In 2019, SBA provided charge-off loan data for SBA-guaranteed loans to franchise investors in Burgerim, Complete Nutrition, Experimac, Massage Envy, Subway and Dickey's Barbecue. Please provide an updated analysis of the default rate for each of these franchise brands as well as Dental Fix and I Heart Mac & Cheese franchises. Please provide default rates nationally and by state as of the end of 2021 for these franchise brands.

As noted in previous correspondence, SBA has the administrative authority to help franchise business owners avoid deceptive practices. These include:

- Require that only franchises that include historic revenue data in its Financial Disclosure Document (FDD) under Item 19 are eligible for SBA guarantees on loans;
- Prohibit franchise corporations, their franchisor brokers, or recommended loan brokers from disclosing revenue data that is in direct conflict with the information contained in a FDD;
- Publish SBA-loan default data quarterly by franchise brand;

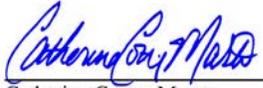
⁹<https://www.cortezmasto.senate.gov/imo/media/doc/Franchise%20Report%20from%20the%20Office%20of%20Senator%20Cortez%20Masto.pdf>

- Prohibit SBA guarantees on loans for franchises that include mandatory arbitration, prohibitions on franchisee associations or other unfair practices; and
- Establish a franchisee helpline for franchise owners facing problems.

We support two bills to provide protections for franchisees: (1) The SBA Franchise Loan Default Disclosure Act, (S. 2162), which requires SBA to publish loan performance data for all franchise brands and (2) the Small Business Administration Franchise Loan Transparency Act, (S. 1120), which requires the disclosure of financial performance data for all SBA-guaranteed loans. This legislation is not necessary; the SBA can implement these protections administratively and improve outcomes for small business owners, workers, communities and taxpayers.

We look forward to meeting with you to discuss the steps the SBA can take to protect franchisees from unfair and deceptive practices. Please respond to this letter no later than April 15, 2022.

Sincerely,



Catherine Cortez Masto
United States Senator



Elizabeth Warren
United States Senator

CC: The Honorable Hannibal "Mike" Ware, Office of Inspector General, Small Business Administration
The Honorable Lina M. Khan, Chair, Federal Trade Commission
The Honorable Noah Joshua Phillips, Commissioner, Federal Trade Commission
The Honorable Rebecca Kelly Slaughter, Commissioner, Federal Trade Commission
The Honorable Christine S. Wilson, Commissioner, Federal Trade Commission
Mr. Sam Levine, Director of Enforcement, Federal Trade Commission

Brandon Moore
brandon.c.moore@gmail.com

March 13th, 2022

The Honorable Ben Cardin
Chairman, Senate Committee on Small
Business and Entrepreneurship
509 Hart Senate Office Building
Washington, DC 201510

The Honorable Rand Paul,
Ranking Member, Senate Committee on Small
Business and Entrepreneurship
167 Russell Senate Office Building
Washington, DC 20510

Dear Chair, Ranking Member, and Members:

On behalf of Dental Fix Rx Franchisees, both current and former, we are writing to voice our support for not only Senator Catherine Cortez-Masto's two bills that she has introduced, but for what she currently stands for. Over the past five years I have been organizing Dental Fix Rx Franchisees to help alleviate themselves of the negative impacts that this franchise has had on our livelihoods, as well as our families. Catherine Cortez-Masto has been a consistent champion of Franchisee Rights and has zeroed out, with surgical precision, the issues that currently plague the franchising industry.

As Senator Cortez-Masto discussed in her letter Dated March 1, 2022, addressed to the Honorable Administrator Isabel Guzman, of the Small Business Administration, this franchisor, Dental Fix Rx, has settled claims with both the Commonwealth of Virginia¹ and Washington State² and has been found to have made serious misrepresentations during the Franchisee's Due Diligence process, including providing Illegal Earning Claims, and omitting material information from the sales process.

We are continuing to pursue other state level Investigations as well, and our participation in the public process is because of our strong desire to continue pushing this effort, as many families are prevented from receiving the proper closure needed to close out this chapter of their life and move on. A large reason we must resort to political action of this magnitude is because of the difficulties with recovering via civil litigation when a Franchise Agreement is involved, as well as the Franchisor's aggressive litigation tactics to keep this issue out of the spotlight, but that is a different effort than what we ask of you today.

Dental Fix Rx's Illegal Earning claims became the basis and justification for a series of 55 SBA Backed Loans for this Franchise. To date, 48% of the SBA Backed Funds allocated to this Franchisor, has been charged off. To quantify the losses to taxpayer, out of the over \$6M in SBA Backed Money issued to this franchisor, over \$3M has been charged off, and likely refunded to the bank. This makes Dental Fix Rx loans one of the riskiest, and poorest performing Franchises that the SBA has provided funds for in recent history. While the dollar amount is relatively low compared to other brands with similar issues, I can assure that the impact of this loan on a franchisee who relied upon the illegal earnings claims, is immeasurable.

¹ <http://www.unhappyfranchisee.com/dental-fix-franchise-violations-va>

² <https://dfi.wa.gov/documents/securities-orders/S-19-2776-20-CO01.pdf>

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The two bills being discussed, The SBA Franchise Loan Transparency Act of 2021 (S. 1120) and the SBA Franchise Loan Default Disclosure Act of 2021 (S. 2162) are both a vital step in the right direction when it comes to improving pre-sales disclosures of Franchise Performance. Had Dental Fix Rx Franchisees had this information available to them, and presented within the correct context, it would have allowed Prospective Franchisees to make more informed decisions about whether to purchase this franchise.

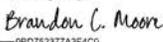
In recent media discussions, this issue has been likened to the Student Loan Fraud crisis, where unscrupulous educational institutions were using government backed loans to fund their business. This is no different than that scenario. In fact, the Franchisor in this scenario stopped growing after the SBA Loans ceased being issued to this brand, and now is no longer franchising. They are unable to sell new units, train new employees, and stopped developing the brand, thus depriving the franchisees of the investment they made into the franchise, the investment made with SBA backed money.

I have included flyers and communication from this Franchisor that indicate the Loan Program for Dental Fix Rx was custom made by the SBA for this Franchisor and was used to deceive franchisees into thinking the SBA endorsed this franchise. Also attached, is an excerpt from the deposition of David Lopez, Dental Fix Rx's CEO, where he blames the SBA Loan for causing the Franchisees to fail and refers to SBA Funds as Monopoly Money. This was prior to being held accountable by Washington and Virginia. I have also attached a letter dated February 7th, 2019, where an Administrative Wage Garnishment Hearing Officer validates the numerous claims of False Certifications in connection with my personal loan, he then goes on to compare me to a robbery victim before explaining that I need to repay the loan.

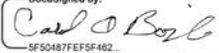
Co-signing this letter of support with me, are 22 additional current and former Dental Fix Franchise Owners, who have all obtained these loans. Together we all hold, or held at one time, over \$3.5 Million of SBA Backed Debt to this franchisor, or about 45% of the \$7.5 Million loan volume. Many of us are bankrupted as a result, or have had their retirements delayed, or are otherwise financially hamstrung because of this loan. Our families continue absorb the impact of these loans by not being able to save for children's education, save for our own retirement, or even basic qualities of life such as home ownership. For Committee Members in Maryland, Washington, New Jersey, Illinois, Florida, Idaho, and Louisiana, I will be working with these signatories over the coming days to put them in touch with your office, so that you can firsthand hear the impact of this scheme from your constituents.

In closing, we kindly request that this committee supports Senator Cortez-Masto's efforts, including her two bills. We also ask that, per the recommendations in her report titled "Strategies to Improve Franchise Model", that an investigation be opened within the SBA, with the goal to seek borrower relief and hold the franchisor, Dental Fix Rx, accountable wherever possible. We do not wish this scenario to happen to any other of our fellow citizens, and these actions are the first step towards ensuring that.

V/R

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 Brandon Moore
 PracticeWorks, LLC
 Haymarket, Virginia

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Carol Boyle, CA Boyle, LLC
Mesa, Arizona

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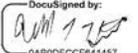
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Steven Moore, Blue Blanket Enterprises
Carmel, Indiana

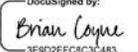
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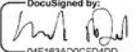
Scott Flanery, Milkota, LLC
Cave Creek, Arizona

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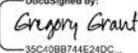
Charles Hunter, Hunter Repair, LLC
Metairie, Louisiana

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Brian Coyne, Coyne Holdings, LLC.
Dunedin, Florida

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Mark McDonald, Dental Equipment Services
Potomac, Maryland

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Gregory Grant, DFX Idaho, LLC
Boise, Idaho

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Marc Boyler, Marc Boyler Company, LLC
Monmouth Junction, New Jersey

DocuSigned by:

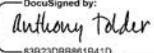
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Ronald Rasavong, Midwest Precisions Tools
and Equipment, LLC.
Mount Prospect, Illinois

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Mark Dirato, Four D Enterprises, Inc
Brick, New Jersey

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Anthony Tolder, ART Services LLC
Houston, Texas

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James Moretti
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James Moretti, AJA Enterprises Inc.
New Milford, New Jersey

DocuSigned by:
Humberto Gomez
ADAABC210A8B462

Humberto Gomez, Dental Tech LLC
Arlington, Texas

The 14th Franchisee cannot participate publicly, due to speech limiting provisions in a forced settlement agreement. The alternative was Bankruptcy.

DocuSigned by:
Gregory Easley
A7D6BR2723834E5

Gregory Easley, JNG Enterprises, LLC
Temple, Texas

DocuSigned by:
Yun He Ho
25CC3CD1D275489

Yun He Ho, Rey Ventures, LLC
Kew Gardens, New York

DocuSigned by:
Mario Garcia
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Mario Garcia, GMA's Dental Fix, LLC
Houston, Texas

DocuSigned by:
Crystal Wingo-Anderson
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Crystal Anderson, Caja Bleu Inc
Fishkill, New York

DocuSigned by:
Jason Patrick
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Jason Patrick, JP's Service and Sales
Hampton, Virginia

DocuSigned by:
William Mullen
B31453DC79DA41B

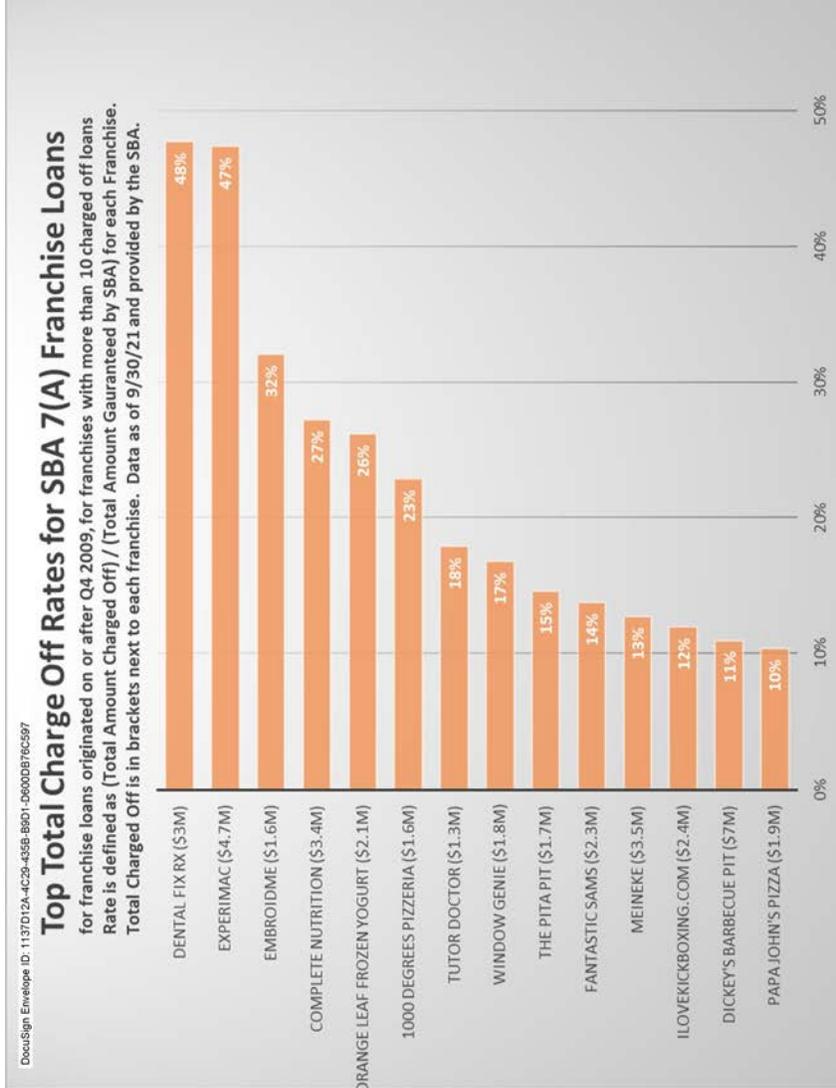
William Mullen, W.C.M. Enterprise, Inc.
Toledo, Ohio

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Zuhair Ibrahim
9AB93B64558A435

Zuhair Ibrahim, Ibrahim L.L.C.
Alexandria, VA

DocuSigned by:
Ron Crigger
99820A923B04135

Ron Crigger, RC Concepts, Inc.
Spokane, Washington



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Brandon Moore <brandon.c.moore@gmail.com>

Fwd: First Financial SBA Program Flyer

Frank Schultz <cfrankschultzjr@gmail.com>
To: brandon.c.moore@gmail.com

Thu, Mar 10, 2022 at 8:42 PM

----- Forwarded message -----

From: <scott@dentalfixrx.com>
Date: Mon, Nov 14, 2016, 12:26 PM
Subject: First Financial SBA Program Flyer
To: charles schultz <cfrankschultzjr@gmail.com>

Charles,

Please find the details of our SBA financing program attached. They will finance \$150k which provides you with the initial investment as well as six months working capital. Feel free to reach out to Jelena. Her info is on the flyer. The program was created for Dental Fix by the SBA. They turn around approval in 72hrs and fund within 45 days.

Scott

Scott V. Mortier
EVP of Business Development
Dental Fix RX, LLC
4380 Oakes Road, Suite 814
Davie, FL 33314
773.255.4095 Cell
561.455.9907 Fax
scott@dentalfixrx.com
www.dentalfixrx.com
[Facebook](#)
[Twitter](#)

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274K



Dental Fix RX
 4380 Oakes Road, Suite 800
 Davie, Florida 33314
 Tel: (954) 320-7610 Fax: (954) 587-2551

\$150,000 SBA Express (Working Capital)



The SBA Express Loan makes it easier to process and fund low dollar loans up to \$150,000!

Program Specifics

- Start Ups/Existing / Home Based
- No bankruptcies, judgments or liens
- CANNOT have over two Bank inquiries
- 675+ Credit Score
- 2.25% Provider / Application Fee Upfront
- APPLICATION ONLY (once approved must submit a financial package for verification)
- Approval within 5 to 7 business days

Start Ups and Existing Businesses

- Up to \$150,000
- Verification of documents (financials and SBA forms 4506T, 1919)
- Interest Rate is Prime Rate (WSJ) plus 2.75% up to 4.75%
- SBA / Bank Fees
- SECURED with UCC 1on business assets
- Term 10 Years
- Closes within 30 to 45 days
- FUNDS

The SBA Express is a streamlined process that is **easier, quicker and faster** it reduces lender transaction cost, and increases access to working capital for small business, franchisees and entrepreneurs.

Call Jelena Kuchar at (800) 956-7313

1 doing the loans.

2 Q All right. So you've used that phrase "people
3 don't have skin in the game."

4 A Yes.

5 Q So if somebody takes out a loan for, say,
6 \$120,000 --

7 A Yes.

8 Q -- and they personally sign in that loan --

9 A Yes.

10 Q -- your -- in your terminology they don't have
11 skin in the game?

12 A Correct. They're using other people's money.

13 Q And what about the fact that the bank will sue
14 them on their personal guarantee and take \$120,000 from
15 them?

16 A When we looked at the number of franchisees
17 that failed, the vast majority on it -- I don't -- don't
18 quote me on the number, but I want to say we looked at
19 the data. It was like 90 percent of our failures were
20 the ones that took bank loans. So for me my correlation
21 of it was, I don't have any skin in the game.

22 If Brandon would have taken the money from his
23 savings account or from his wife, he wouldn't have
24 walked. He would have known that was real money. But
25 because it was Monopoly money, it was bank's money, he

151

1 just walked. I saw it happen over and over and over
2 again. And as soon as we saw it happen, I stopped.

3 Q So you think that somebody who has the United
4 States government ready to come after them \$120,000
5 walks away because they think it's Monopoly money?

6 A Yes.

7 MR. EINHORN: Objection, argumentative.

8 THE WITNESS: Yes.

9 BY MR. SILVERMAN:

10 Q You do think that?

11 A Well, you -- that's what the data tells me.

12 Q Okay.

13 A At the time that I did it, I didn't think
14 that.

15 Q Okay.

16 A I take loans all the time, and I realize
17 they're real and I got to pay them back. And I've never
18 defaulted on a loan in my life. So I don't believe that
19 way, but I believe the people that -- in Dental Fix,
20 that's how they were thinking, yes.

21 Q Okay. The third Lopez down you say -- you
22 start saying, "Yet we didn't have any franchisees suing
23 us."

24 I'm not going to ask you about that sentence.
25 Then it says, "You know the attorney, Robert Zarco, who

Lopez, David 30(b)(6)



U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF GENERAL COUNSEL

Brandon C. Moore
12121 Sierra Sunset LN
Gainesville, VA 20155

Re: U.S. Small Business Administration Loan # 7758315007
Administrative Wage Garnishment Decision

GARNISHMENT HEARING DECISION

On October 9, 2018 the Department of the Treasury proposed to collect money which it claimed you owed the United States Small Business Administration (SBA) through wage garnishment. You objected on the ground that you did not owe the debt. More specifically, you argued that you were damaged as a result of fraud on the part of the franchisor, Dental Fix RX¹, and its associates. You have asked me to make a careful, independent review of your account. I have done so, and based on the information and argument you presented, as well as information supplied by the SBA and the Federal Government generally, I have decided that you owe the debt. Therefore, the wage garnishment may go forward at this time.

13 C.F.R. § 140.11(f)(8) provides:

(8) Burden of proof.

(i) The SBA will have the burden of going forward to prove the existence or amount of the debt.

(ii) Thereafter, if you dispute the existence or amount of the debt, you must establish by a preponderance of the evidence that no debt exists or that the amount of the debt is incorrect. In addition, you may present evidence that the terms of the

¹You've asked for a continuance of these proceedings while your litigation against Dental Fix remains unresolved. For reasons which will be clear later in the text, I deny this request.

repayment schedule are unlawful, would cause you a financial hardship, or that collection of the debt may not be pursued due to operation of law.

SBA has met its burden of showing that you owe the debt by producing the Note (Exhibit # 1) and the guarantee (Exhibit # 2). The burden thus now falls on you to show, by preponderance of the evidence, that you do not owe the debt.

To that end, you make the following assertions, and support them with evidence:

(1). **The use of proceeds (SBA 1920) was falsified.** The use of proceeds form shows that the full amount of the loan would be used for working capital. In fact, you intended to use the use of proceeds form to pay for franchise fees, training fees, inventory and other items, and you did in fact use the proceeds to pay for many of these items. You assert that Jelena Kuchar, a loan broker from First Financial, falsified the use of proceeds form after you submitted a correct form to her. You imply that Dental Fix, RX, “steered” you to Ms. Kuchar as your broker.

(2). **False certification as to your salary.** You assert that Ms. Kuchar instructed you to tell the bank that your salary was \$115,000 a year – even though she knew that you had quit the job which paid you that amount in order to undertake your new business. You complied with her instruction.

(3). **Fee disclosure form did not identify Jelena Kuchar as the loan broker.** The forms 159 which you signed identified Cindy Watson, Jelena Kuchar’s boss, and Rebecca Houk, a Celtic Bank employee, as the individuals to whom you paid a fee. They did not claim that you paid a fee to Jelena Kuchar.

(4). **The broker claimed that SBA guaranteed only 50% of the loan, when in fact SBA guaranteed 85%.**

(5). **The broker backdated your training certificate.** Although your loan was disbursed on September 16, 2015, you didn’t complete your training until October 2, 2015. However, Ms. Kuchar presented the bank with a training certificate which bore the date of September 4, 2015.

In reviewing these assertions, I cannot conclude that either the lender, Celtic Bank, or SBA was in any way responsible for the fate which befell your business. If anything, your evidence shows that Celtic and SBA were victims of the skullduggery you describe – skullduggery with which you, however innocently, acquiesced.²

While it may be the case that you have a valid claim against Dental Fix, First Financial, Ms. Kuchar and others involved in your initial decision to take out this loan, you have no claim against Celtic Bank or SBA, and have presented no reason that you should not repay your loan to them.

Imagine that I have borrowed ten thousand dollars from you, and we agreed that I would pay it back, at 7% interest, at a thousand dollars a month. I intend to pour this money into my business, and I believe that it will improve my business by enough so that I can repay the loan you made to me. But on my way to my place of business, a robber mugs me and takes the money. Can I receive absolution for my debt to you, based on the bad acts of the robber? Of course not. Similarly, your debt to SBA is not in any way diminished by the purported fraud of the franchisor and its associates.

I find and conclude that you owe the debt, and that wage garnishment may go forward.

You may avoid wage garnishment by voluntarily making payment in full. If you wish to repay voluntarily, you may contact the Department of Treasury's Administrative Wage Garnishment Liaison at 888.826.3127.

This decision applies only to the government's efforts to seek administrative wage garnishment against you and not to any effort by the government to use other means to recover the debt you owe it.

Reconsideration: You may seek judicial review in Federal District Court.

²In fact, not all of these allegations may be as significant as you appear to believe they are. It may well be the fact that your fee went to Ms. Wilson, Ms. Kuchar's boss. In any event, it does not matter who the fee went to, unless Ms. Kuchar (or Ms. Wilson!) has been debarred from working on Federal loans. The fact that SBA's guarantee was 85%, rather than 50%, is of no consequence to you; in either instance SBA will aim at recovering the entire debt, and return the lender's *pro rata* share to it. Finally, if the loan broker back-dated the training certificate so that it reflected that you had completed training before disbursement when you actually completed training slightly after disbursement, it is material from the standpoint of damages only if you did something between disbursement and training completion which you wouldn't have done had you completed the training before disbursement.

Legal Protection From Employer Adverse Action: Your employer may not discharge you from employment, nor take disciplinary steps against you, as a result of an AWG Order, nor can a prospective employer refuse to employ you as a result of this action. If any such actions for such reasons are taken against you, you should seek legal counsel as to your rights against your employer.

Limitation of Scope of Decision: This determination affects only the debt described in the notice of garnishment, and is totally separate from any notice of proposed Federal payment offset or garnishment which you may have received from any other Agency.

Pursuant to 13 C.F.R. § 140.11 (f) (12), this is the final agency decision for purposes of judicial review under the Administrative Procedures Act (5 U.S.C. 701 *et seq.*)

Executed this 7th day of February, 2019.



T.C. Treanor
Administrative Wage Garnishment Hearing Officer
Room 7221
409 3rd Street SW
Washington, DC 20416

c. Administrative Wage Garnishment Liaison
P.O. Box 830794
Birmingham, AL 35283-0794

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March 24, 2022

Honorable Ben Cardin
Chair, Committee on Small Business & Entrepreneurship
428A Russell Senate Office Building
Washington, DC 20515

Honorable Rand Paul
Ranking Member, Committee on Small Business & Entrepreneurship
428A Russell Senate Office Building
Washington, DC 20515

RE: Response to March 16, 2022 Committee Hearing on the SBA and Franchising

Dear Senators Cardin and Paul,

Thank you for holding this hearing on this important issue. This is an issue I have been working on for years. I respectfully submit this letter to the record.

I founded Franchisee Advocacy Consulting, focusing my efforts to advance franchisee causes through engagement and advocacy. I have been a Subway franchise owner since 1988, owning up to 6 outlets in Nevada and California, and currently owns 3 outlets. I was Chairman of the Coalition of Franchisee Associations (CFA) from January 2012 through January 2018 and remain on as a Director and served on the North American Association of Subway Franchisees (NAASF) as a Director from 2000-2002 and 2005-2010, serving as NAASF's first President, CEO, and Chairman in 2000-2001. In 2019, I was named Director of Public Affairs and Engagement for the American Association of Franchisees and Dealers (AAFD). Simply put, I have skin in the game when it comes to franchising.

Watching this hearing was somewhat frustrating to me as so much of what I heard was "The government needs to get out of the way of business owners."¹ In fact, I question whether many had even read the bills as testimony seemed to stray, even invoking the PRO Act which neither of the bills in question have anything to do with. Both bills sponsored by Senator Cortez Masto require no work by the prospective franchisee looking to open the business or trying to get an SBA loan. In fact, all these bills do is provide them with more information as to whether the franchise they are considering is a reasonable risk. These bills DO NOT increase government spending, in fact, they are intended to reduce SBA loan defaults which will save the government (and taxpayer) money.

¹ Testimony of Mr. Bryan Tipton, https://www.sbc.senate.gov/public/_cache/files/3/2/32f827bf-b722-4cc9-a1ee-9756559f7e53/1897868DBDFE2AFE72A3DA797244389C.tipton-testimony.pdf

Franchising is a great business model that allows many to enter business ownership. It sells itself as being proven business models, with little to no experience needed. Yet, you heard it in the testimony before the committee, from Mr. Aaron Yelowitz that, "In my view, the tables show very modest differences in charge-offs in the SBA data. Between fiscal years 2010-2014 as well as 2018 onward, the difference in charge-offs between franchisees and independent businesses is statistically insignificant for the 7(a) loan program."² If this is true, we have to question the success of the franchise business model, as a "proven" model should show lower rates of charge-offs. The problem is that we have brands that are proven and have a high level of success, but we also have many that are failed or unproven models. In these cases the failure can perpetuate itself, resulting in many business failures, and ultimately a higher level of charge-offs. Through the two bills that were discussed, and the data they would provide to a prospective franchisee, these failed or unproven brands could be more quickly identified, many prospective franchisees would not buy that franchise, they would not be financially ruined, and the SBA would not have another charge-off.

I was honored to be Senator Cortez Masto's witness at a July 17, 2019 hearing in the Committee on Banking, Housing, and Urban Affairs, Subcommittee on Economic Policy titled *Economic Mobility: Is the American Dream in Crisis?* I have attached my full statement from that hearing. I discussed the outcomes of when franchisees are given improper revenue numbers in the buying process, how unrealistic projections they were given were used on their SBA loan applications, and the negative impact it has had on their lives, in addition to the charge-offs on the SBA loans. And the impact of a failure is far beyond the charge-off to the SBA, many of these franchisees lost everything, including their home, and defaulted on equipment and site leases, lines of credit, and credit card debt.

These bills should have bipartisan support. They simply ask for a higher level of transparency, which will protect both the franchise buyer, and the taxpayer. I ask that you support S.1120 and S.2162.

Sincerely,



Keith R. Miller
Principal, Franchisee Advocacy Consulting

Cc: Senator Catherine Cortez Masto

² Testimony of Mr. Aaron Yelowitz, https://www.sbc.senate.gov/public/_cache/files/5/2/52b292fb-45c2-4f6f-9832-f5764ee3666e/FC619EE4B6671BBF518D712A8E7B3521.yelowitz-testimony.pdf

Economic Mobility: Is the American Dream in Crisis?

United States Senate
Committee on Banking, Housing, and Urban Affairs
Subcommittee on Economic Policy
July 17, 2019

Statement of Keith R. Miller
Principal, Franchisee Advocacy Consulting

Chairman Cotton, Ranking Member Cortez Masto, and members of the Subcommittee and Committee, thank you for the opportunity to speak to you today. My name is Keith Miller. I am a 30-year franchise owner of Subway. Notice I use the term “franchise owner”. While more commonly called a franchisee, and I will often use that term today, I prefer “franchise owner” reminding everyone that when you buy a franchise, you own something, you are an owner. I am a past president of the North American Association of Subway Franchisees (NAASF) and for 6 years, I was chair of the Coalition of Franchisee Associations (CFA), the largest franchisee-only organization in the country. I have long been an advocate for franchise owners. In 2018, I started a small business, the Franchisee Advocacy Consulting with the tagline, “Advancing franchisee causes through engagement and advocacy”. I have been a voice in the industry for those that are not able to speak or are afraid to speak up.

With my background and expertise, today I will speak specifically about the franchise industry, the good, the bad, the ugly. I will talk about the opportunities the industry provides to realize the American Dream, and how that dream can turn into a nightmare. I will discuss about how the government has become an enabler for bad franchises, and finally, I will discuss oversight and transparency which I believe will clean up the industry and help rebuild some trust to help others realize the American Dream.

The franchise industry is large¹, and, over time has allowed many to realize their American Dream. The lodging industry, for example, is one that has allowed many early-generation immigrants to successfully own their own business and prosper. There are many examples of great brands that have provided these opportunities. The franchise business model itself is a brilliant business model, and one I support. However, because of little transparency and oversight, it is also an industry with far too many examples of predatory franchise companies that take advantage of prospective entrepreneurs and leave them overworked, despondent and broke. We hear the lure of the industry as it advertises to be your own boss, with proven business models, and no experience necessary. On top of that, the industry targets those most vulnerable; immigrants, veterans, and retirees. Remember, I am a small business owner myself, hardly one that advocates for an abundance of regulation. But, in the case of the franchise sector, the government provides inadequate oversight and access to money which can encourage fraud and lead to failed businesses and demoralized business owners.

Let’s first talk about oversight. Most believe that this large sector is heavily regulated. The Federal Trade Commission (FTC) does regulate presale disclosure through the Franchise Rule. The FTC requires a prospective franchisee receive a Franchise Disclosure Document, or FDD. But I ask, how many of you knew that the FTC doesn’t even collect the FDD, and on the first page of all FDDs it specifically states in bold print, **“Note, however, that no governmental agency has verified the information contained in this document”**. The FTC permits franchisors to write terms into a contract that denies franchisees the right to buy goods from a lower-cost source, prohibit franchisees from organizing into an association and even bans them from sharing their experience with current and future franchise owners. It permits contracts that allow franchisors to provide fraudulent financial information outside of the FDD. The FTC allows contracts that force franchisees into arbitration which can make it easier for the franchise corporation to take the outlets of successful franchisees through minor infractions. I wouldn’t call that heavily regulated.

Why is this important? Let’s look at the securities industry for example. If you invest \$100,000 in a stock, what is your risk? Well, worst case, you could lose your entire investment, so your risk is \$100,000. Now let’s look at a franchise, so I’ll ask the same question, if you invest \$100,000 in buying a franchise, what is your risk? No, it’s not the \$100,000 you invested; it’s much more, it’s all the assets you own! Personal guarantees are required in most franchise agreements, and often extend to the immediate family, so a separate

business entity provides little to no protection of personal assets. Yet here we have an industry with no governmental agency even reviewing the documents. In addition, once the ink is dried on the signed franchise agreement, there are no federal laws or regulations specific to the franchise industry to manage the relationship of that investment. There are 19 states that do have some level of relationship laws. This lack of oversight is vastly different from any industry I can think of when it comes to protecting the investors. Most laws and regulations are there to protect the investors first. Boards of directors have that fiduciary responsibility to protect those investors. In the franchise industry, the primary investor, as a class, is the franchise owners. However, the franchisees are not shareholders, they are considered stakeholders, therefore the franchise company has no such fiduciary responsibility to them or their investment.

Let's look at some numbers. Franchise Grade, a market research firm that analyzes franchisee investment risk published an article titled, "Can A Few Bad Apples Spoil the Industry Investment?"ⁱⁱⁱ It looked at 1,900 franchise systems, using disclosure information from 2010 through 2014. In that 5-year period, they noted 168,585 new business units had opened, but also that 138,825 businesses had closed, for a net gain of only 29,760 businesses. Even more concerning was the difference between the top and bottom quartiles. While the bottom quartile accounted for 25% of the openings, it closed double the outlets opened and accounted for 61% of all closed outlets. With full disclosure and better oversight, very few of those failing stores would have opened and many entrepreneurs and employees would have been better off.

If this high level of failure were happening with private capital, it would be bad enough. But the Small Business Administration's loan guarantee programs enable failure and fraud. In 2013, the Government Accountability Office released a report (GAO-13-759) that showed during the previous 10 years, "SBA guaranteed franchise loans under its 7(a) program totaling around \$10.6 billion. SBA made guaranteed payments on approximately 28 percent of these franchise loans, representing about \$1.5 billion."ⁱⁱⁱ This means that twenty-eight percent of franchise loans saw the owner not only lose their business, but all their assets. Franchise owners post significant collateral – their savings, their homes, other land or property they hold. When SBA loans are charged off, this means the franchise owner has already lost her or his collateral. Charge offs are paid for by higher fees charged to future borrowers and lenders and occasionally, the taxpayers. In fact, charge offs in the 7(a) program are so high now that the Trump Administration requested an appropriation of \$99 million.^{iv} Defaults should be rare, and for many franchise brands they are. But some franchise brands have very high levels of defaults, a fact that is very difficult for a potential franchise owner to learn.

Too many – the franchise corporations, the SBA, some in Congress -- only look at SBA funds showing how many businesses have opened, and how many jobs they created. Unfortunately, none of them stand up and count the businesses that fail, and the jobs that are lost. Failing franchisees cannot pay good wages. Some have nearly no employees; the franchise owners and family members work non-stop just to keep the business afloat. Franchise owners struggle to pay back the loan and meet the terms of a decades-long contracts.^v Failing franchisees struggle to pay any wages and payroll taxes.

This concern is bipartisan. Ranking Member Cortez Masto recently sent letter outlining her concerns of four specific brands to the SBA and asking for loan performance information on these brands.^{vi} In 2014, then Senator and Budget Ranking Member Jeff Sessions inquired about the "moral hazard" that was created by the SBA when banks can profit from poorly underwritten loans.^{vii}

Let's look at some examples of the breakdown in this industry, and how dreams have been shattered. Amin Abdelkarim is an immigrant from Egypt, who moved to the Dallas area. He worked double shifts at the Dallas

Fort Worth airport and saved enough money to think about going into business, in search of his American Dream. He ended up purchasing a Dickey's Barbecue Pit franchise. He was given the FDD, and a spreadsheet showing estimated startup costs, and was provided assistance with applying for an SBA 7(a) loan. Unfortunately for him, the estimates given were grossly incorrect, and all his startup capital was spent getting the business open. He opened his business in August 2018, and Amin contacted me in September 2018, one month after opening, asking for help. He was already broke, he could not pay his SBA loan, and feared he would lose his home, rendering his family homeless. Dickey's idea of assistance was reminding him of the 60-month liquidated damages clause in his contract. His other option was to sell his business to a buyer Dickey's found, for pennies on the dollar. Either way, he knew his SBA loan was going in default, and he was going to lose all his assets. At one point he said to me, "in a few weeks, I will find myself, my disabled wife, and my 89-year old mother in law in the street, with no house, no car, and no money".

Some will argue, it's his fault, he didn't have the skills to be a business owner. This is what franchisors will always blame, the franchisee was not a good owner, so it's not the company's fault.

Here's the problem in the industry.

When a franchise is sold, both the franchise corporation and the franchise business should profit. However, the franchise corporations, brokers, and/or "consultants" make money up front. They earn a profit from the initial franchise fee, then the franchise corporation continues to make money on the ongoing royalties, most often based on revenue, not profit. The franchise corporation has little risk, while the franchise owners often struggle to make a decent living.^{viii} The franchise owner has all the risk. The bank profits from the loan, a loan they often would not approve without the SBA's guarantee. In fact, banking regulators do not even consider government-guaranteed loans and do not get involved when those loans fail.

You may wonder why the SBA continues to guarantee loans when in fiscal year 2018, Dickey's started with 562 units, opened 72 new units, yet had terminations and ceased operations of 113, for a net loss of 41 outlets.^{ix} Add in 44 transfers, many of them forced for pennies on the dollar, and you have a disorderly attrition rate of 28% of the total outlets in a single year. During the last 10 years, Dickey's took out 246 SBA loans, and 41, or 17% have been charged off. A recent survey of 201 of 336 Dickey's BBQ store operators representing 330 stores, found that 85% of current store owners would NOT open a Dickey's franchise. Of those 201 store owners, 84% said that buying a Dickey's franchise did NOT meet their expectations. These results do not include Amin and others like him who no longer have their store. And it's not just Dickey's - the SBA has a history of backing poor performing brands.^x

Companies' pushes to sell more franchises has led to many franchisees that should not have been provided access to government-guaranteed loans. Again, many profit without risk. But take, for example, Experimac.^{xi} This is a brand that started franchising in 2016. At the end of 2018, their disclosure document showed 101 franchised units in the United States. They started franchising just 3 years ago, yet have received 77 SBA approved loans, of which 23, or 30%, have already been charged off. Experimac is part of the United Franchise Group, which markets multiple franchises. They send prospective franchisees to a hand-picked loan broker. UnhappyFranchisee.com reported that this loan broker participated in a podcast in 2017 where he stated he had coordinated funding for 70 Experimac franchise owners, including facilitating SBA Express loans through Celtic Bank, 401k Rollover for Business Start-up (ROBS), and equipment leases. He further stated that financial projections are the biggest challenge but commented "I do that".^{xii} This means he could provide financial projections that were not part of the FDD and would not be violating any kind of disclosure requirements.

Mark Shor retired from his IT job at a university and bought an Experimac franchise in Henderson, just outside of Las Vegas area. The franchisor directed him to the loan broker mentioned above that helped him apply for and obtain an SBA 7(a) loan from Celtic Bank. The loan broker provided him a projection spreadsheet that showed nearly \$700,000 in revenue for the first year, \$995,400 the second year. The current FDD shows the highest volume franchised location at revenue of \$822,375, with an average unit doing \$410,639. I personally was contacted by this franchise group, and when I asked if I could expect to do revenue of at least \$500,000, I was told in an email from a company representative that they have "locations in our Million Dollar Club". This of course is false. Mark has continued to work his business, still open while those around him have closed, but still bleeding cash. The only way he is surviving is by monthly dipping into his retirement to pay the SBA loan to keep it current. While he may be the exception and not default his loan, his retirement nest egg will be painfully depleted.

Complete Nutrition is a shocking story of abuse of franchise owners. At the beginning of March this year, the Complete Nutrition franchise notified franchisees that at the end of March, they would no longer be a franchise company. Franchisees could continue as a retailer for the nutrition company with no support from the company or could opt out of their contract for a \$10,000 termination fee. On April 1, the Point of Sale system for franchisees was cut off, but not before the company data mined the customer information. A few days later, an email went out telling all customers that their local Complete Nutrition had been sold but not to worry, customers could order online 24/7. A few days after this, the company claimed that was a mistake, but is that really believable? Franchisees have told me that the company continues to market to their old customer base, selling products online significantly cheaper than they can in the brick and mortar location. Many of these franchisees recently bought into Complete Nutrition, at a price of \$49,500, but now have a franchisor that has cut them off and is stealing their customer base. More than half the Complete Nutrition locations were financed using SBA loans. Before the recent actions, 12% have been charged off over the last 10 years.

Michael Hataway is a Complete Nutrition franchisee in Reno. Since the franchisor has pulled support, sent out the email that they have been sold, and aggressively marketed online sales, his sales have crashed. His finances and personal life are in shambles and he is heading towards default of his SBA loan. Jamie Stephens, a franchisee with 5 stores in North Dakota and one in Minnesota had 5 SBA loans totaling around \$1.5 million when Complete Nutrition completely changed their business environment. But don't worry, the franchisor has kept their \$49,500 franchise fees collected per outlet, some from the last few years.

Finally, Huntington Learning Centers. This brand, and the SBA lending to it, prompted an SBA Inspector General audit (Report No. 11-16) in 2011. The IG found that SBA 7(a) loans to Huntington Learning Center franchises had significantly inflated first year revenue projections.^{xiii} Bob Spada from Connecticut was one such franchisee. He was given a loan consultant to work with and applied for a loan with Banco Popular. His first-year revenue projection given was just over \$500,000, and he received a \$300,000 loan. As he started to fail, he wondered why he was so short of projections. He found others opening at the same time were also far short of their projections. Then he found out that actual first year revenue numbers for an average center was really \$249,000, less than half his projection. A mature location had average revenue in the low \$400,000s. As he dug into the reasons for this projection, he discovered the devious means. To qualify for that \$300,000 loan, he would need about a \$75,000 profit that first year to meet the required debt service coverage ratio. To reach that profit level, and reverse engineering the numbers, you would need just over \$500,000 in revenue. The numbers given to all these franchisees were false. It was clear that Huntington's consultant had reverse

engineered the profit numbers just to qualify for the loans. And when the loan was funded, Huntington Learning Centers collected a \$60,000 franchise fee. Banco Popular sold these loans off on the secondary market for a nice profit. The only one really left with the liability was Bob, the franchisee. Bob was forced to file bankruptcy and lost everything. He's also an example of the true cost of to the economy. While the SBA claims the costs/losses are managed within the program, that is only true for the SBA loan amount. In reality, Bob, in an effort to make the business a success ran up huge credit card debt and got a home equity loan. The total losses of his mortgage, equity loan, and credit cards more than doubled the losses of the SBA loan. Who accounts for that loss to the economy?

Corrective Action Steps are Possible

When an industry tolerates deception and fraud, it is damaging to those entrepreneurs who see their dreams become nightmares. It is terrible for communities when stores close, jobs are lost, and homes are foreclosed. Here are some steps that need to be taken to rectify some of the issues in the franchise industry. Many are contained in the Coalition of Franchisee Associations' comments to the FTC of the Franchise Rule Review, which is attached. Some of those highlights are:

- Provide adequate resources and ensure staff will review compliance of the Franchise Rule, make the disclosure documents publicly available, and confidentially receive complaints so the franchisee is not subject to retaliation.
- Provide for a Private Right of Action. It is obvious the FTC does not have the resources nor the priorities to enforce their own Franchise Rule. A private right of action would provide damaged franchisees the right to sue for violations. Congress must legislatively make this change.
- Prevent FDDs from including disclaimers which allow franchisors to amend their policies outside the specific language of the franchise agreement. This is most often accomplished by including a statement that the franchisee must follow all policies in the most current Operations Manual. However, items often included in the Operations Manual are not operational issues, but contract changes. For example, including a section that limits how many outlets you can sell to a single buyer.
- Require the FDD be a binding contract for the term of the franchise agreement, which may be 5, 10, or up to 20 years. If the FDD is used as the part of the due diligence in purchasing the franchise, and the franchisor can change any of the practices that have been disclosed, then what value is the disclosure?
- Prohibit disclosures outside of the FDD, made both informally and by third parties.
- Make all FDDs publicly available on the FTC website.
- Increase disclosures on revenues, costs, loan repayment, defaults, and other data for both first year and mature units.

The next step is to require increased FTC disclosure of brands qualifying for SBA 7(a) loans. Any franchise owner receiving an SBA loan should get 1) disclosure of average first year revenues for franchised outlets and 2) disclosure of first year ceased operations and transfers. While opponents will claim that they do not want more government oversight on private business, they have no problem asking for government-guaranteed

money to line their pockets. This change is not to curtail SBA lending, but to ensure more money is provided to viable brands at reduced fees and rates.

Finally, it is time for Congress to pass comprehensive franchise relationship legislation that protects franchise investors after the contract is signed. This legislation should include:

- Rights to association without interference or retaliation and an end to non-disparagement clauses that prohibit potential franchise owners from learning about the business from current franchise owners.
- Termination rights, to ensure fair due process is afforded to all franchise owners.
- Transfer rights, to ensure the right to transfer and monetize the equity the franchise owner has earned.
- Property rights to ensure the franchise owner is protected on the assets they have paid for.

Conclusion:

In summary, the franchise business model can be, and should be, a model for economic mobility, and realizing the American Dream for generations. However, leaving the industry to police itself is not working, and destroying many lives, while profiting a few individuals and corporate executives. There is no reason for this. Access to SBA money should be the model of transparency of the industry, one that ensures the best underwriting procedures. The industry forgets who the real investors are, the franchise owners, and their government fails in protecting those who invest, employ, support, and pay taxes in every community across this country.

ⁱ International Franchise Association. National Impact of Franchising. Updated 2018. Retrieved from <https://franchiseeconomy.com/>

ⁱⁱ Franchise Grade. "Can A Few Bad Apples Spoil the Industry Investment?" May 5, 2015. Retrieved from: <https://www.prweb.com/releases/2015/05/prweb12698529.htm>

ⁱⁱⁱ GAO. Review of 7(a) Guaranteed Loans to Select Franchisees. GAO-13-759: Published: Sep 10, 2013. Retrieved from: <https://www.gao.gov/assets/660/657723.pdf>

^{iv} U.S. Small Business Administration, FY2020 Congressional Budget Justification and FY2018 Annual Performance Report, 2019. Pages 34-35. Retrieved from: <https://www.sba.gov/sites/default/files/2019-04/SBA%20FY%202020%20Congressional%20Justification%20final%20508%20%204%2023%202019.pdf>

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https://smallbusiness.house.gov/uploadedfiles/the_fy_2020_presidential_budget_final_.pdf

^v Bennet, Julie. Franchise Times. "Taking off the gloves; Commercial cleaning franchisees sue." August 2009. Retrieved from: <https://www.llrllaw.com/wp-content/uploads/2015/10/Taking-off-the-Gloves-%E2%80%93-Commercial-cleaning-franchisees-sue.pdf>

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March 6, 2022

Statement of Michael Galatte of Nevada

My name is Michael Galatte and I am a small business owner of Burgerim franchise here in the Las Vegas area who was approved for an SBA 7A loan that is secured with my wife's and my personal assets. I am writing to urge your support for Senator Cortez Masto's two bills

- **SBA Franchise Loan Transparency Act (S. 1120)** - mandates the SBA to require that any franchise borrower who receives an SBA-guaranteed loan have historic revenue and store closing/sales information from the franchise corporation.
- **SBA Franchise Loan Default Disclosure Act (S. 2162)** - requires the Small Business Administration publish default rates for the past decade for each franchise brand. The default rates shall be updated quarterly. This transparency would ensure that the franchisee borrower has access to loan performance data needed to make informed business decisions prior to taking on a decades-long financial commitment.

I am in strong support of these bills knowing the overwhelming number of Burgerim and other franchise owners who have taken enormous risks personally and financially. We all had the same American dream to be a small business owner and support our local neighborhoods and surrounding communities. Being a first time restaurant owner, I had to learn very quickly how the SBA loan process works and how easy it was to become overwhelmed. I feel that the franchisor must have complete transparency and accurate financial information. These bills will help protect those who have put their life savings, homes, personal guarantees, and additional loans from the possibility of losing everything they have saved and worked for.

My story with this franchise began in 2017 with a simple Instagram ad I saw stating that the barrier to entry with low franchise fees and low start-up costs. After meeting with them in person, we decided to move forward and they made a promise to return our franchise fee if we couldn't find financing. We did struggle to find a bank on our own to provide the funds for the build-out, furniture, and equipment. It wasn't until we were about to have to ask for our money back, they put us in contact with a person who could get us with the right bank. We used a financial firm that the franchise recommended to create our business plan needed for the bank, they recommended the attorney to overlook our lease agreement, they provided other outside lenders that turned out to be scammers (one private lender kept our loan deposit money of \$5,000). We found out in the weeks after our restaurant opened that the sales projections the franchise and the financial firm told us and gave to the SBA were false. The projections the financial firm gave the SBA were falsified by as much as 50% month over month. They completely lied to us and falsified documents to the SBA on projected sales and income over time.

In September of 2019 is when we (franchisees) were starting to see a major decrease in communication with the corporate office. I received a call from the owner of Burgerim, Oren Loni on November 27th 2019 asking me to help him drive his cars from Los Angeles to Las Vegas. I declined and the next day we (the franchisees) found out that he had fled the country and it was believed he went back to Israel. We were left to fend for ourselves with no help from corporate. We had no one advocating on our behalf which was required by the franchisor in the Franchise Disclosure Documents. This led to extremely high food costs, high point of sales fees and being stuck in long-term contracts that we could not get out of. Since we were a "franchise" our vendors would not let us make any changes to our accounts without the permission from corporate. At this point, after the owner Oren Loni left, 95% of

the corporate office was laid off, and we couldn't get in touch with anyone. This was extremely frustrating and caused many sleepless nights.

As a first time restaurant owner, I chose to go with a franchise to help guide me along the way to ensure a smooth start and some hand holding. That is what we were paying for. We received none of that. In fact, it has left my wife and me in a dire situation and on the verge of losing everything we own. I have not stopped fighting to stay afloat and won't give up. I could continue to tell my personal story but I don't want to take up too much of your time. Just please know that my wife and I are good members of the Las Vegas community. Las Vegas has been my home for over 25 years and has provided a great life for my family. I wanted to give back to the city that gave me so much. I never saw this coming. And Covid was just another devastating blow to our business.

In closing, I again urge you to support these bills to protect those who are taking all of the risk. Protect those who have come from other countries to start a new life here in America and are taken advantage of because of their lack of clear understanding but without changes to the SBA lending process with franchises, I'm afraid that it will just continue to cost tax payers more money and higher loan defaults.

Sincerely,

Michael Galatte
Burgerim Franchise Owner
Las Vegas, NV 89178

March 14, 2022

Dear Chairman Cardin and Ranking Member Paul:

I write to you today to support the efforts of Senator Cortez Masto who will be testifying in a Small Business and Entrepreneurship hearing this Wednesday, March 16.

Unfortunately in January 2018, I made the decision to purchase a Burgerim franchise to open an outlet in Buffalo, New York. I was given sales and cost data outside of the required disclosures, that I later found false. Based on those numbers, I applied for and received an SBA 7(a) loan. My Original loan with the SBA (7a) was \$345,000, plus I invested all of mine and my family's life savings upwards of \$125,000 from January 2018-September 2019. I was told that I would have the support of BurgerIM's construction team and open within a year, however it took me almost 2 years to open without any help from the corporate team at BurgerIM. My loan is at a 7% interest rate and year-to-date I have already been charged \$16,662.94 in interest.

Burgerim has been found by the state of California to have committed fraud in the franchise sales process, and recently the FTC filed suit against Burgerim. Since the original Franchise Owner (Oren Lori) fled the United States.

I ask you to listen to Senator Cortez Masto's testimony and think of me when you hear how lives have been destroyed by the failure of oversight meant to protect free markets. If the two bills, S.1120 and S.2162 had been in place and that data available, I would not have purchased this franchise, I would have not qualified for our SBA loan, and I would not be in my current situation.

Thank you for your consideration and I am free to answer any questions you may have.

Sincerely,

Junaid Malik

Buffalo, NY

FINANCING

BURGERIM'S GROWTH HAD A NOTABLE ENABLER: THE SBA

The government backed loans to more than 100 franchisees of the brand, which the FTC sued in a rare enforcement action last week. Many are struggling to pay them back.

By **Jonathan Maze** on Feb. 10, 2022

Restaurant Business

Jay Hackstaff worked with Outback restaurants for 25 years before he decided to go on his own. He'd saved his money over the years and decided to buy a franchise, in 2018 choosing a California upstart called Burgerim that was selling franchises all over the place.

He received a Small Business Administration (SBA) loan, which a loan broker working with the company helped to complete. Cost overruns took the loan from \$400,000 to \$600,000. The business struggled when it opened, and a year later the company's founder, Oren Loni, closed up shop and fled the country, abandoning the business and its operators.

More than three years later, Hackstaff is still paying off that loan—even though the state of California ordered Burgerim itself to give refunds to franchisees, and even though the U.S. Federal Trade Commission sued the brand and Loni for misleading operators. Hackstaff often struggles to pay the \$8,000-per-month loan payment and often gets calls from collectors threatening to call the loan and take his house.

"You're assuming they're doing their due diligence and vetting out every single franchise they approve," Hackstaff said of the SBA. "I trust the government is going to do their job. And if there's any issues with the franchise, they'd say this is not going to happen."



Hackstaff is hardly alone. When Burgerim came out of nowhere to sell those 1,500 operators on its franchise offering over just a three-year period, one of its biggest enablers was the U.S. Small Business Administration.

The SBA backed loans made to 119 Burgerim operators, according to a report on franchising last year by U.S. Sen. Catherine Cortez Masto, D-Nev. Those operators received loans totaling \$38 million. That total represents as many as a third of the total number of Burgerim locations ever opened, meaning the brand relied heavily on government-backed financing.

“It really brings up the question of, is there any government vetting, prior to the government guaranteeing loans?” said Keith Miller, a franchisee advocate who has closely investigated the Burgerim problem. “The fact that the government guarantees loans give some sense of security to franchisees that it has been vetted.”

The bigger problem is the personal guarantee. When Hackstaff and other borrowers sign to get an SBA-backed loan, they have to sign a personal guarantee—something wealthier franchisees that get private financing don’t have to sign. If the loan fails, they stand to lose their house as a result. Those threats to take Hackstaff’s house, in other words, are very real.

“They’re destroying the lives of people that did nothing wrong,” said Jonathan Fortman, a **franchise attorney out of Missouri**. “All they did was try to open a business and rely on people to treat them fairly.”

The SBA operates a number of loan programs. Its most notable is the 7(a) program. It's designed to help people get financing they otherwise could not get on their own. Without it, many small businesses like catering companies or construction contractors or plumbers could not get their start.

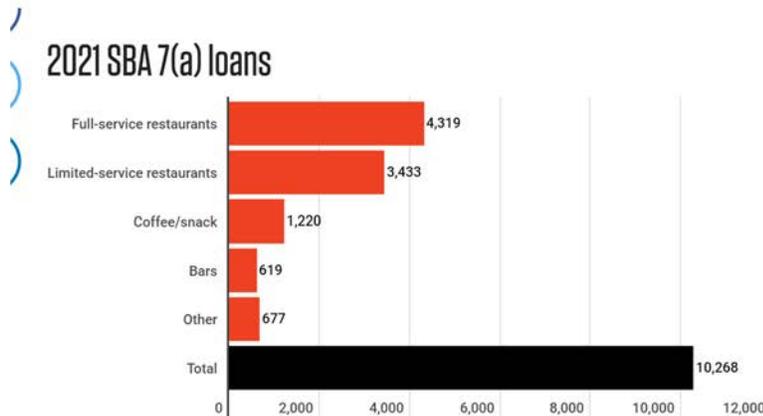
Nor could many restaurants, the most frequent users of the program. The SBA financed more than 10,000 such loans to restaurants during the federal government's 2021 fiscal year—or about one out of every five 7(a) loans it made during that period.

A lot of these loans fail. One study suggested one out of ten SBA-backed loans fail, in part because they're going to more at-risk borrowers, and because a lot of businesses ultimately fail.

Franchisees get a lot of these loans. About a third of the loans made to restaurants last year, and 40% of the amount approved, went to franchisees, according to federal data.

It's not certain how many franchise loans fail, but franchises are no safer than any other investment. Caroline Bundy Fichter, a franchise attorney with the Bundy Law Firm out of Washington, estimates that she refers about a third of her franchisee clients to bankruptcy attorneys—and most of them received SBA loans.

That's one of the problems in franchising. Many people invest in franchises believing it's safer than simply starting a concept from scratch, yet they fail just as often.



Source: U.S. Small Business Administration

While there are many well-proven and solid brands that have franchisees receiving SBA loans, such as Domino's and Jersey Mike's Subs, there are many made to systems where problems run rampant. A number of franchises sell aggressively to anybody willing to sign an agreement. They may also deploy other strategies that make it tougher for operators to make a profit.

The SBA will stop lending to franchises with too many failures, as it eventually did with Burgerim. But it could take a while, if it ever happens. Quiznos signed as many franchisees as it could in the early 2000s, ultimately becoming the country's second-largest sub chain. Yet it also had one of the industry's highest rates of default on SBA loans. Franchisees complained loudly about a number of things, notably high charges for food and paper.

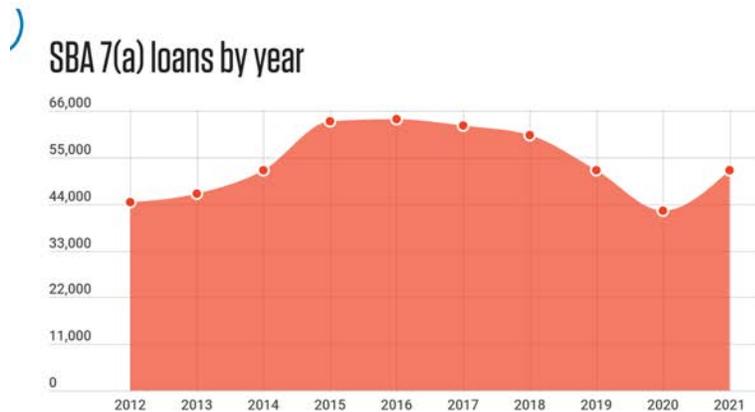
The brand began closing units by the hundreds in 2009. Today it has less than 5% of the locations it had at its peak in 2006.

The SBA at one point published default rate data for franchises whose franchisees received such loans. But the agency stopped doing so a decade ago. That makes it more challenging to determine how much franchisees in a brand are struggling.

Cortez Masto last year introduced a bill that would require the SBA to publish quarterly default rates on loans by brand over the preceding 10-year period. She also reintroduced legislation that would require franchise owners receive historical revenue and store closure information before they can receive an SBA loan.

"The availability of SBA loans and the lack of transparency on default data gives people an opportunity to gamble with other people's money," Bundy Fichter said. "The people who are hurt in the end are the franchisees and the taxpayers."

What's more, she said, it can be difficult at best for borrowers of SBA loans to get breaks. While landlords or franchisors might provide assistance for struggling franchisees, the SBA rarely does.



Source: U.S. Small Business Administration

Burgerim officially opened its first location in the U.S. in 2016. It signed up more than 1,500 franchisees by the end of 2019. The state of California estimates these operators paid nearly \$58 million in franchise fees.

The FTC said in its lawsuit filed last week that the company intentionally misrepresented the risks of the franchise to those buyers—including promising refunds, the vast majority of which it never provided. It was the first time the agency took action against a franchise in 15 years.

The SBA remains an open question. Yet as part of Burgerim’s strategy to get stores opened, the company steered a number of franchisees into government-backed loans.

Hackstaff agreed to open a Burgerim in 2017, and he was approved for an SBA loan the next year. He worked through a broker and the company, which handled most of the paperwork. They even wrote the business plan the SBA requires of every franchisee that provides the loan.

Included in the plan were financial projections suggesting the brand would be profitable its first month, and remain profitable thereafter.

That gave lenders confidence to OK an increase in the size of the loan by 50% to fund cost overruns in the buildout, a common problem for Burgerim franchisees that were able to get that far.

But Hackstaff’s restaurant never came close to the revenue projections in the business plan, projections that were used to fund the loan. And his restaurant was never profitable.

Just more than a year after his store opened, Oren Loni abandoned the brand, leaving behind unopened mail and files in the company’s California offices. Operators wouldn’t hear from the brand for weeks, until December 2019 when an attorney sent a letter to franchisees that the company would file for bankruptcy. That filing never came.

Hackstaff estimates that he has put \$1 million into Burgerim. He is not confident that he will see any of that. “I’ll never see any penny of that,” he said.

But he still has that \$8,000 monthly payment, a payment inflated by the increased size of the loan along with a variable interest rate. Hackstaff has since dropped the Burgerim brand and come up with his own concept, Handcrafted Burger Bar. He said the restaurant is fine, though he keeps it open largely to pay off that SBA loan.

Some months that loan amounts to 21% of his revenues. “It’s ridiculous,” he said.

Fortman said the same thing. The SBA, he said, expects franchisees to do their due diligence. “They want a business plan,” he said. “But if the franchisee is getting defrauded, and the bank necessarily gets defrauded, then [the SBA] has to shoulder some of this risk. They gave you the loan.”

Restaurant Business

AS ITS DELIVERY BUSINESS THRIVES, LITTLE CAESARS TARGETS

<https://www.restaurantbusinessonline.com/financing/burgerims-growth-had-notable-enabler-sba>

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United States Senate
COMMITTEE ON SMALL BUSINESS & ENTREPRENEURSHIP
WASHINGTON, DC 20510-6350
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March 31, 2022

Dr. Aaron Yelowitz
Professor of Economics, University of Kentucky
Senior Fellow, Cato Institute
2265 Barnwell Lane
Lexington, KY 40513

Dear Dr. Yelowitz,

Thank you for appearing before the Committee on Small Business and Entrepreneurship on March 16, 2022, at the hearing titled "Small Business Franchising: An Overview of the Industry, SBA's Role, and Legislative Proposals."

Enclosed are questions for you that have been submitted by Senators Young and Marshall for the hearing record. Please submit your answers to these questions by Thursday, April 14th via electronic mail to kathryn_eden@sbc.senate.gov. To facilitate the publication of the record, please reproduce the questions with your responses.

Again, thank you for your assistance. Please contact Meredith West of the Minority Staff at meredith_west@sbc.senate.gov with any questions you may have. We look forward to reviewing your answers.

Sincerely,



Benjamin L. Cardin
Chairman

**Senate Committee on Small Business and Entrepreneurship Hearing
March 16, 2022
Follow-Up Questions for the Record**

Question for Dr. Yelowitz

Question from:

Senator Young

According to the International Franchise Association, in 2021, there were over 16 thousand franchised businesses in Indiana, providing 194 thousand jobs and yielding \$15.9 billion in economic output for the state's economy.

Unfortunately, as with most industries, there will always be bad actors in the marketplace; but whatever troubles may burden certain franchise systems, these are typically one-off instances.

Therefore, as Congress continues to examine the franchising model, it is important that we do not pursue regulations or proposals that will damage a system that works quite well – especially given the growing economic uncertainty with respect to soaring inflation and supply chain constraints.

QUESTION 1:

Can you elaborate on why light-touch regulations, which are currently in place under the FTC's Franchise Rule, allow the franchise industry to foster the conditions for the economic success?

Since 1978, the Franchise Rule has been the primary federal regulation governing the franchise sector. According to the International Franchise Association, the FTC Franchise Rule has helped empower current and prospective franchise owners by providing for clear and consistent disclosure of information at the outset of all franchise relationships.

Questions from:

Senator Marshall

QUESTION 1:

In your estimate, what impact will the NLRB's proposed rule change to joint employer standards have?

Expanding joint employer standards, whereby franchisors can be held responsible for actions taken by their franchisees, could disrupt the entire concept of franchising as a business model. These types of provisions would discourage entry into franchising, encourage exits, and ultimately lead to fewer franchised establishments in the marketplace. In turn, this would lead to reduced competition and higher consumer prices.

QUESTION 2:

Would a bill to codify a joint employer standard as a person that, "directly, actually, and immediately (and not in a limited and routine manner) exercises significant control over the essential terms and conditions of employment" be beneficial for independent franchisors?

The most relevant legislative proposal here is the "Protecting the Right to Organize" Act, or the PRO Act, which is pending before the Senate. Among its many provisions, the bill would codify into law an expanded "joint employer" standard, whereby franchisors can be held responsible for actions taken by their franchisees. This clearly makes franchisors much less willing to partner with local entrepreneurs, thereby reducing small business ownership opportunities in the franchise world. Another PRO Act provision that is likely to considerably affect the franchising economy is the so-called "ABC test" to determine when individuals can be classified as independent contractors. In its present form, the provision's language is quite broad, suggesting that franchisees – who are independent contractors and separate employers from franchisors – could end up being classified as employees of their franchisor.

Senate Committee on Small Business and Entrepreneurship Hearing
March 16, 2022
Follow-Up Questions for the Record

Questions for Ms. Stapf

Questions from:

Chairman Cardin

Senator Cortez-Masto has introduced legislation, S. 1120, to require the SBA to provide additional information to potential borrowers about default rates on SBA-backed loans to franchisees. This is not information currently provided in the FDD.

QUESTION 1:

Do you think seeing data on SBA franchise lending would be beneficial to prospective franchisees?

As I stated during testimony, I do believe that more information is helpful to prospective franchisees. That's why we strongly support the FTC Franchise Rule and the way it promotes the disclosure of information in the franchise community. There are concerns, however, that a one-size-fits-all legislative requirement to disclose financial information could disadvantage the smallest, emerging franchise brands that lack the financial history of larger, more established brands.

QUESTION 2:

Are there other SBA data that would be beneficial to franchisees to review before taking on an SBA-backed business loan?

I am supportive of SBA loan programs. These loan programs are essential to helping small businesses get off the ground, giving opportunity to those who may not have access to capital realize the American dream. While legislation intended to ensure more transparency and disclosure may be well-intended, an inflexible legislative requirement may ultimately harm both the smallest franchisees and the smallest franchisors.

Questions from:

Senator Inhofe

Value of the Franchising Model

Ms. Stapf, one of the most successful staffing companies in the U.S. is headquartered right in the heart of my home state in Oklahoma City.

And it's a franchise – Express Employment Professionals started in 1983 with \$150,000 in sales and has since grown to be a multi-billion-dollar company with over 800 locations worldwide.

Despite what some think, franchisors are not primarily out to make money at the expense of franchisees.

In fact, franchising works because when franchisees succeed, the franchisor succeeds, and Express is a testament to this reality.

QUESTION 1:

Ms. Stapf, can you speak to the value of this mutually beneficial relationship, and how that pushes back against prevailing negative narratives about the franchising model?

I have been dedicated to franchising for the past 10 years as both a franchisor and franchisee and have seen firsthand how it can change lives and change communities. The economic benefits of the franchise model are undeniable, and the state of franchising has never been stronger than it is today. There are so many of us that have an entrepreneurial spirit but don't necessarily have the expertise to be efficient at all aspects of running a business. A franchise offers that structure, that framework. Without that, there would be challenges – challenges that would cost time and money (and frustration). Most of these are avoidable if you have a solid franchise system at your back.

Regulatory Burdens

Ms. Stapf, a decade ago, gentleman named Jay Diaz received an SBA loan and proceeded to open an Express Employment location in Connecticut.

Mr. Diaz is a former marine who had no prior business experience – yet he took a \$60,000 SBA loan and grew his business to \$9 million a year in sales, now using his additional resources to serve his local community.

It's clear that the franchising model works for franchisors and franchisees.

Yet some of my colleagues across the aisle want to place more burdens on franchisors through added regulation and reporting requirements – in our bureaucratic world, more regulation is almost never the right way to solve problems.

QUESTION 2:

Ms. Stapf, how would additional regulatory requirements harm businesses operating under the franchising model?

The success of the franchise model hinges upon smart and effective regulation. Since 1978, the FTC Franchise Rule has served as important guidelines for franchisors to prepare and provide an extensive pre-sale disclosure document to prospective franchisees. That policy decision to favor pre-sale disclosure instead of rigidly prescriptive regulation has led to the franchise sector flourishing with thousands of franchise companies in more than 230 industries contributing considerably to entrepreneurship as well as the economy’s growth and vitality. Changes to current regulatory framework could bring on more confusion for prospective franchise owners, discourage entry, encourage exits, and ultimately lead to fewer franchised establishments in the marketplace.

Questions from:

Senator Young

The Federal Trade Commission’s Franchise Disclosure Document (FDD) is required by law to make it easier for potential buyers to compare one franchise opportunity against another. Among the FDD’s 23 standardized sections, franchisors have the option whether or not to disclose “financial representations,” also known as “Item 19,” which will show how profitable, or unprofitable, their franchise could be.

Fortunately, the market typically rewards transparency with more opportunities for success, but there are several reasons why some brands choose to leave out such information, including being newer to the market.

QUESTION 1:

With several proposals aiming to regulate the franchise industry, do you believe requiring franchisors to disclose financial performance data could impede market competition?

I strongly support the current framework in which the FTC Franchise Rule has served as an important tool to provide for how franchisors present extensive pre-sale disclosure information to prospective franchisees. That policy decision to favor pre-sale disclosure instead of rigidly prescriptive regulation has led to the franchise sector flourishing with

thousands of franchise companies in more than 230 industries contributing considerably to entrepreneurship as well as the economy's growth and vitality.

QUESTION 2:

Furthermore, if new disclosure mandates were issued, do you foresee these mandates making it harder for newer franchises to break into the marketplace?

Franchising is perhaps the most important business growth strategy in American history. Today, there are more than 740,000 franchise establishments, which support nearly 7.6 million jobs and \$674.3 billion of economic output for the U.S. economy. The economic benefits of the franchise model are undeniable, and the state of franchising has never been stronger. I hope senators will support the successful, existing regulatory framework that continues to promote an economic environment that allows new entrants into the marketplace.

Questions from:

Senator Marshall

QUESTION 1:

Ms. Stapf, some are under the impression that an expanded joint employer standard would be good for franchisees like you. As a franchisee, would you want your brand to share liability with you?

No. I'm an independent business owner. If another business is liable for my actions, then that business will have the ability to take steps to eliminate that risk in ways that may not be positive for my future as a business owner.

QUESTION 2:

In your estimate, what impact will the FRLB's proposed rule change to joint employer standards have?

Again, I'm in independent business owner. The PRO Act will disincentivize new start-up businesses from franchising. Rather than assume the risk, they will grow using a corporate model instead, which will take away ownership opportunities for people like me. As a franchisee, I'm an independent entrepreneur. Local franchise business owners like me have direct control over their own hiring practices, working conditions, wages, and hours of operations. I pay my own taxes and am responsible for following all applicable local, state, and federal laws.

QUESTION 3:

Would a bill to codify a joint employer standard as a person that, "directly, actually, and immediately (and not in a limited and routine manner) exercises significant control over the essential terms and conditions of employment" Be beneficial for independent franchisors?

As a franchisee, I'm an independent entrepreneur. Local franchise business owners like me have direct control over their own hiring practices, working conditions, wages, and hours of operations. I have a separate employer identification number from all of my franchisees. We all file our own taxes and are responsible for following all applicable local, state, and federal laws. The PRO Act's independent contractor test features an "A" prong that most franchises would likely fail. That's because the A prong sets up a conflict of laws with the federal Lanham Act, which requires franchisors to have the same control that the PRO Act prohibits.

Senate Committee on Small Business and Entrepreneurship Hearing
March 16, 2022
Follow-Up Questions for the Record

WRITTEN RESPONSES OF Robert W. Emerson,
Huber Hurst Prof. of Business Law, Univ. of Florida

Some of Prof. Emerson's articles are on the Social Science Research Network at <http://ssrn.com/author=86449>

April 2022

Questions for Mr. Emerson

Questions from:

Chairman Cardin

The SBA Franchise Loan Default Disclosure Act, S. 1120, would require franchisors to disclose historical revenue data before SBA could guarantee a loan to a franchisee.

QUESTION 1:

While much of the focus has been on Item 19 of the FDD, why and how do you think item 20, which requires historical data on franchise locations, could be tweaked to address some of the same issues?

ANSWER:

Information about other franchisees in the system (e.g., numbers, success or failure, and contact persons) can be as important to the success of the prospective franchisee as the financial data. The Item 20 human element can, no doubt, be more engaging and easier to follow for many prospective franchisees, so any way to provide even more interpretative remarks, explanation of the numbers, and contact information (e.g., for ease of reaching current franchisees of the franchisor) would be highly useful. Franchisee advocacy groups and associations could be excellent resources for discovering and publicizing ways to tweak the Item 20 historical data. As

with many FDD items, Item 20 has data which, if approached strategically, can provide the potential franchisee more insights into how to make the most of the disclosures he/she has received.

A key takeaway for any reader of practical advice to franchisee “wannabes” is to speak with a number of different franchisees for the system that they may join. Anything that can ensure a prospective franchise investor look carefully at all Item 20 tables, and engage with conversations with a number of current and former franchisees (and even franchisees of competitors, if possible), would certainly be commendable.¹

We know from commentary and cases the tremendous importance of obtaining timely and accurate Item 20 data. In *MTR Capital, LLC v. LaVida Massage Franchise Development, Inc.*, 2020 WL 6536954 (E.D. Mich. 2020), a franchisor had not updated its Franchise Disclosure Document (FDD) with quarterly reports of franchisee closures in Item 20. The franchisor was held to have committed a deceptive and unfair trade practice under Florida's Deceptive and Unfair Trade Practices Act (FDUTPA). The FDUTPA prohibits “[u]nfair methods of competition, unconscionable acts or practices, and unfair or deceptive acts or practices in conduct of any trade or commerce.”² Under the FDUTPA, a plaintiff must still allege facts plausibly suggesting that the defendants' actions were likely to cause consumer harm. The plaintiff does not have to be a consumer, but it must prove the elements showing injury to consumers. Under the FDUTPA, a consumer is one that is engaged in the purchase of goods or services.³ The court's approach is representative of how Item 20 violations would likely be treated under any state's “Little FTC Act.”⁴

Here are two sources for general understanding of Item 20:

1. Cristina Merrill, *The Most Important Items in an FDD: Item 20 - Outlet, Transfer and Franchise Owner Information: With information on a brand's number of outlets, transfers and*

¹ Even when a commentator distills the key information to focus upon to simply a few things, Item 20 may be key. See Joel Libava, *These 3 FDD Items Really Matter*, U.S. SMALL BUS. ADMIN. (BLOG), Feb. 8, 2019, <https://www.sba.gov/blog/these-3-fdd-items-really-matter> (recommending that prospective franchisees go through all FDD Items with an attorney, but identifying “the three most important items contained in the FDD” as being Items 7 (Estimated Initial Investment), 9 (Franchisee's Obligations), and 20 (Outlets and Franchisee Information)).

² Fla. Stat. § 501.204(1). The FDUTPA also states, “[i]t is the intent of the Legislature that . . . great weight shall be given to the interpretations of the Federal Trade Commission,” and it further declares that violations of the FTC Act, 15 U.S.C. § 41 et seq., constitute FDUTPA violations. Fla. Stat. §§ 501.203(3)(a), 204(2).

³ *Midway Labs USA, LLC v. South Service Trading, S.A.*, 2020 WL 2494608 (S.D. Fla. 2020).

⁴ See Altresha Q. Burchett-Williams et al., *Claims Under the “Little FTC Acts”: The High Stakes of Risk and Reward*, A.B.A. 33rd ANN. FORUM ON FRANCHISING, Oct. 13-15, 2010, at 5 (“each state and the District of Columbia has at least one statute aimed in some way at prohibiting unfair and/or deceptive trade practices”) (citing Carolyn L. Carter, *Consumer Protection in the States: A 50-State Report on Unfair and Deceptive Acts and Practices Statutes*, NAT'L CONSUMER LAW CTR. (2009)). It is much typically easier to win a claim under Little FTC Acts than under common law claims for fraud. Burchett-Williams, et al., *supra*, at 5. The wording of these state statutes addressing unfair and deceptive behavior (Little FTC Acts) “is usually drawn from the FTC Act, the Uniform Deceptive Trade Practices Act, or the Uniform Consumer Sales Practices Act.” *Id.* at 2.

more, Item 20 is not to be overlooked and provides valuable insights that hint at overall system health, 1851 FRANCHISE, Jan. 24, 2020, <https://1851franchise.com/the-most-important-items-in-an-fdd-item-20-outlet-transfer-and-franchise-owner-information-2712074#stories> (discussing some valuable things to which franchises should pay attention in order to avoid falling in pitfalls.)

2. Scott Milas, *Five Tips for Reading an FDD (Franchise Disclosure Document)*, June 8, 2021, SCOTT MILAS, FRANCHISE COACH, <https://scottmilasfranchisecoach.com/2021/06/08/five-tips-for-reading-an-fdd-franchise-disclosure-document/> (For item 20, a franchise should, among other things, not judge based on the number of outlets but on the percentage of pledged outlets).

An ongoing issue, of course, is how up-to-date any information in an FDD is, perhaps especially with Item 20. Attentiveness in this area is certainly necessary.⁵ With more resources, the FTC or state regulators no doubt could focus on pressing franchisors while alerting potential franchisees and their representatives.

 You testified that most prospective franchisees currently have access to significant amounts of data, but may not have the experience or resources to adequately process it all before entering a franchising agreement.

QUESTION 2:

Is it possible to distill down the most vital information for easier analysis? If so, what would that look like, and are there regulatory or statutory changes necessary to carry it out?

ANSWER:

With 23 different Items and many subsections, certainly there is some information provided to prospective franchisees which is quite likely more important than other information, at least for most parties.⁶ For example, balance sheets, required initial investments, financial performance

⁵ Sandra Gibbs, *Franchise Alert: Updating Disclosure Documents to Reflect System Changes During the Pandemic*, MULCAHY LLP, Aug. 13, 2020, <https://www.mulcahyllp.com/blog/franchise-alert-updating-disclosure-documents-to-reflect-system-changes-during-the-pandemic.html> (noting, during the Pandemic, that for Item 20 there was difficulty in reporting "material changes" as some businesses were shutting down permanently and some temporarily). The FDD is to be annually updated, but there also is a requirement for (1) updating the FDD more frequently (with quarterly updates) if there are material changes to various FDD disclosures and (2) in effect, for special, more immediate updates related to financial performance representations. See FED. TRADE COMM'N, FRANCHISE RULE COMPLIANCE GUIDE (2008), <https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf>, at 126-129.

⁶ A search of cases with the phrase "FDD Item" shows that some Items are more popular than others as bases for dispute. Items 19 and 20, along with Item 3 (disclosure of certain legal disputes involving a franchisor or its predecessors, affiliates, parents, or other persons disclosed in item 2) are among the Items that seem to be among the ones most frequently mentioned.

representations, if any (i.e., statements of profits or losses), and information about trademarks, recent and pending litigation, and the growth or losses in terms of franchisees in recent years are all quite important.

Furthermore, the degree of importance is likely to vary depending on industries, particular franchise systems, and individual franchisees. However, the risk of having an executive summary or a distilled list of information is that this will increase even more the chance that prospective franchisees simply will not give much, or perhaps even any, consideration to the FDD disclosures that are not included in the distilled (abbreviated) version.⁷

I think the preferable approach is to make the FDD accessible in such a way that readers can run searches, aggregate data, and otherwise easily do comparisons between different FDDs. Some of that is already possible, but more needs to be done, including providing user-friendly instructions to follow in making use of data-crunching and data-comparison features.

An obvious practical problem is that the FDD is long and that its language often is difficult to understand.⁸ I fear, though, that a somewhat shorter form will still be viewed as lengthy and complicated by many potential franchisees, and that the net effect may mean less (at least certainly no more) reading beyond the distilled version than the present access to the one current, longer FDD receives. In other words, if there is just one “regular” FDD of 240 pages,⁹ as opposed to a distilled version of, say, 40 pages that is in conjunction with that longer 240-page FDD, then in the latter case the “regular” FDD will be even less likely to be thoroughly

⁷ For the arguments favoring the summary FDD format, see Eric H. Karp & Ari N. Stern, *A Proposal for a Mandatory Summary Franchise Disclosure Document*, 35 FRANCHISE L. J. 541, 541-576 (2016). There is a very brief document that could be a valuable learning tool for prospective franchisees, as long as they read it as a start to understanding the FDD, not the beginning *and end* of the process. New North American State Administrators Association (“NASAA”) Instructions for Preparing State Cover Sheets and State Effective Date Page (effective Jan. 1, 2020) (Bus. Franchise Guide (CCH) ¶ 5709), <https://www.nasaa.org/wp-content/uploads/2019/06/New-Franchise-State-Cover-Sheets-Instructions.pdf>, pp. 3-5 (“How to Use This Franchise Disclosure Document” providing some very basic guidance to some of what are usually viewed as among the most important FDD items – Items 3-6, 12, and 19-21 - as well as some basic, practical warnings about franchising).

⁸ Both franchise law scholars and legal practitioners have noted this in numerous articles. See, e.g., Robert W. Emerson, *Transparency in Franchising*, 2021 COLUM. BUS. L. REV. 172, 204 (2021) (“the required [franchise] disclosure document can be quite a lengthy read for prospective franchisees. The sheer number of pages in the typical disclosure can be intimidating and is probably a reason so many franchisees skip the important step of carefully evaluating the material information contained inside the document.”); Karp & Stern, *supra* note 7, at 543 (noting that recent years have seen “the material and marked increase in the sheer amount of information contained in a typical franchise disclosure document.”; contending that this increase in information “makes the document impenetrable and intimidating to most potential franchisees”); Rochelle Spandorf, *Reading the FDD: The Argument Against Simplification*, FRANCHISING.COM (May 4, 2021), https://www.franchising.com/articles/reading_the_fdd_the_argument_against_simplification.html (“the FDD has grown so complicated and voluminous that it is ‘intimidating’ to the average prospective franchisee”).

⁹ A study of 523 FDDs found their length to be a mean average of 251 pages, with the median length being 229 pages. Uri Benoliel & Xu (Vivian) Zheng, *Are Disclosures Readable? An Empirical Test*, 70 ALA. L. REV. 238, 252 (2018).

reviewed. Also, the more condensed the FDD is, the more likely it is to distill away something that may really matter in some circumstances. How often will the franchise “prospects” recognize the need to go from the distilled information and turn to the longer FDD?

The real problem for many prospective franchisees is that they do not hire professionals to assist them – e.g., experienced franchise lawyers and/or others skilled in reviewing the information to which they have become privy.¹⁰ With professionals, they could get the assistance needed to fairly quickly and competently evaluate the available information, conduct additional research as needed, and compare the choices before them (e.g., determining which issues require further exploration; deciding whether to buy a franchise or not; if buying a franchise, settling upon which one; selecting possible negotiation tactics and – more generally – optimal approaches to business planning). The problem is not that there is too much information *per se*, but that an inability or unwillingness to smartly analyze the information at hand, and thereby focus on all factors pertinent to one’s particular situation, leaves the prospective franchisee suffering information *overload*: this potential franchisee does not have too much information, but simply needs to access it in a more useful manner.

As noted, most FDDs are quite long, and their language often is extremely complex.¹¹ This is despite a federal rule requiring the franchisor to provide prospective franchisees an FDD that is written “clearly,” “legibly,” and “using plain English,”¹² meaning that the FDD should “incorporate[] short sentences [and] definite, concrete, everyday language” which is “understandable by a [layperson, that is, a] person unfamiliar with the franchise business.”¹³ Still, the best retort to this criticism may be to concede that there are problems with many FDDs, but focus on what would be a genuine solution to that problem. Of necessity, the rules mandate that the FDD disclose much information. Succinct language should be used as much as possible, but — even more so than shorter words and briefer sentences — three things would be distinct improvements:

1. Make the FDD follow a format by which the accessing of that document, the FDD, can take advantage of searching and data mining features.¹⁴ For potential franchisees and their representatives this would entail, *inter alia*, the ability (a) to search for key words and otherwise access the information therein, and (b) to compare the data across various FDDs. In essence, the modified FTC franchise disclosure process would be modeled on the 2009 rule that the Securities and Exchange Commission (SEC) promulgated concerning “Interactive Data to Improve

¹⁰ Robert W. Emerson, *Fortune Favors the Franchisor: Survey and Analysis of the Franchisee’s Decision Whether to Hire Counsel*, 51 SAN DIEGO L. REV. 709, 723–24 (2014) (citing franchisor lawyers and other franchise law commentators to note the likelihood that unrepresented franchisees will not understand their complex franchise agreements).

¹¹ Benoliel & Zheng, *supra* note 9, at 253 (using the Gunning Fog Index linguistics readability tool to study 523 FDDs and concluding that, while the average franchisee has fourteen years of education (completed community college), prospective franchisees need, on average, more than twenty years of education to understand FDDs on the first reading).

¹² 16 C.F.R. § 436.6(b).

¹³ *Id.* § 436.1(o).

¹⁴ Uri Benoliel, *Have Disclosures Kept up with the Big Data Revolution? An Empirical Test*, BOSTON COLLEGE L. REV. 1-33 (2022).

Financial Reporting.”¹⁵ Like the reports provided per the SEC’s 2009 rule, a machine-readable FDD should save money and time and thus reduce errors (e.g., failing to read, or misreading, key sections of the document). This enhanced FDD would assist data aggregation, help enforcement agencies detect anomalous patterns possibly indicative of fraud, and even further empirical scholarship.¹⁶ While the FTC’s Franchise Rule “aims to ensure that disclosures are *human-readable*,”¹⁷ the disclosures should be more than that. They should be *machine-readable*: (1) in a digital format enabling a computer to easily search and extract error-free data; (2) with a unified structure and standardized taxonomy enabling systematic data extraction and processing; and (3) including uniform but also unique “tags” (e.g., symbols or titles).¹⁸

2. Provide that all FDDs be placed in an online repository (an online public forum) facilitating comparison between different franchise networks. While a few states make FDDs available online,¹⁹ the FTC’s maintenance of publicly available, current FDDs would make information about franchise networks – hundreds of them - so much more accessible, transparent, and thus cheaply acquired.

[The FTC should maintain] a federal franchise registry comparable to the electronically accessible database solution (aka EDGAR) that the Securities and Exchange Commission put in place almost twenty-five years ago, which makes public company filings immediately accessible to the investing public at no cost. Franchisors operating anywhere in the United States would be required to upload their FDD to the federal franchise registry, which would gather and index FDDs and with a few keystrokes accomplish universal informational transparency of all franchise offers. A federal franchise registry would save franchisors the cost of the currently repetitious registration process, a cost measurable not only in dollars, but also in the potential disruption to a franchisor’s sales activities in a Registration State due to regulatory backlog and slow turn-around time. The filing fees that

¹⁵ Securities and Exchange Commission, Interactive Data to Improve Financial Reporting, Release Nos. 33-9002, 34-59324, 39-2461 (Apr. 13, 2009) <https://www.sec.gov/rules/final/2009/33-9002.pdf>. This SEC rule requires publicly traded companies to disclose to the SEC financial statement information in a machine-readable format – i.e., an interactive data format using the eXtensible Business Reporting Language (XBRL). *Id.* at 1.

¹⁶ Benoliel, *supra* note 14, at 13-14.

¹⁷ *Id.* at 25.

¹⁸ *Id.* at 26-27.

¹⁹ Search, CALIF. DEPT. FIN. PROTEC. & INNOV., <https://docqnet.dfp.ca.gov/search/>; Registration Search, IND. SECURITIES PORTAL, <https://securities.sos.in.gov/public-portfolio-search/>; Franchise Registration, MINN. COMMERCE DEPT., <https://cards.web.commerce.state.mn.us/>; Franchise Search, WIS. DEP’T OF FIN. INST., <https://www.wdfi.org/apps/FranchiseSearch/MainSearch.aspx>. A knowledgeable franchisee or researcher thus can spend time on one or more of these sites gathering some FDDs, but access may not be thorough in terms of how many different franchises’ FDDs are indeed stored there, and whether the FDDs are the most current documents. More important, this process is time-consuming and not necessarily feasible for most prospective franchisees or their representatives.

franchisors would pay to upload their FDD annually to the federal franchise registry and each time they make a material change to it during their fiscal year would support the cost to maintain the online database solution. The registry would require a franchisor to consent to service of process in each state in which the franchisor wants to offer and sell franchises to facilitate law enforcement by state agencies. A federal franchise registry would put sunshine on the performance of every franchise system operating anywhere in the United States.²⁰

3. Further admonish prospective franchisees of their need to hire experienced counsel – that it is often “penny wise but pound foolish” to save some upfront costs by foregoing professional advice, interpretative skills (reading and explaining FDDs, contract terms, etc.), and negotiations savvy.

[T]he FTC does not require the franchisor to provide recommendations to the . . . franchisee to obtain counsel in its disclosure documents [citing the FTC Franchise Rule, 16 C.F.R. §§ 436-437]. However, as in other areas of law, this type of disclosure could be the key to addressing and combating the various psychological reasons— overconfidence, overoptimism, and general incompetence—behind why franchisees do not obtain counsel, and thus limit the harmful effects of uncounseled franchisees.²¹

A required notice could explicitly remind potential franchisees that what they are about to sign merits the expert guidance of a franchise attorney. The warning could say:

Before agreeing to become a franchisee, you should consult with an experienced franchise lawyer. As a practical matter, including a long-term savings of time and money, your hiring that lawyer at the outset is almost always a “must.”

Do not trust in your ability, or the ability of others, to decide whether you need a lawyer’s assistance for something this important. Just as a new but persistent physical ailment should lead

²⁰ Rochelle Spandorf, *Can Federal Preemption Solve What’s Wrong with Franchise Sales Laws?* 39 FRANCHISE L.J. 477, 490 (2020), https://www.americanbar.org/content/dam/aba/publications/franchising_law_journal/spring2020/spandorf.pdf.

²¹ Robert W. Emerson, *supra* note 10, at 766. In other nations, such as Australia, where the franchising community is among the most thriving – as a percentage of the total economic activity – in the world, a franchise agreement cannot be signed unless the franchisor receives signed statements from the franchisee stating that the franchisee received independent legal or business advice related to the franchise agreement or chose not to do so. See Trade Practices (Industry Codes—Franchising) Regulations 1998 (Cth) s 11 pt 2 (Austl.); see also Stephen Giles & Rupert M. Barkoff, *Australian Franchise Law: How to Avoid Being a Shrimp on the Australian Franchising Barbecue*, 29 FRANCHISE L.J. 164, 171 (2010) (discussing how franchisors in Australia “must recommend that franchisees seek independent legal and business advice”; stating that Australia’s required warning and franchisee acknowledgement “may sound unwieldy, or perhaps paternalistic, to U.S. lawyers, but [they] operate[] well in practice”).

you, as a matter of personal health, to do more than just treat it yourself but to see a medical doctor, so you, when buying a franchise, should not “go it alone.” To proceed without a lawyer, you simply do not know enough about this franchise, the legal nature of the franchise documents, and the many relevant laws.

The nature of professional expertise (medicine, law, etc.) is that even an otherwise very smart and experienced individual, if not a professional in that field, needs professional assistance. Also, your lack of training and experience in law likely makes you unable to assess whether and how a legal expert (a franchise lawyer) could help you. So, no matter how smart or experienced you may be generally or even for this particular type of business, you probably cannot accurately weigh the costs of “going it alone” versus paying for legal counsel. Very often in hindsight, a franchisee who failed to hire a lawyer deeply regrets that he or she did not hire a lawyer at the outset.²²

There is concern that some franchisors exaggerate or outright lie about the historical performance of their brand. You testified that giving franchisees a private right of action or preventing the use of arbitration clauses could be helpful.

QUESTION 3:

Can you please elaborate on these recommendations and how they could protect franchisees?

ANSWER:

Private Right of Action

Every state has enacted one or more statutes against consumer fraud and other deceptive trade practices, and these laws typically permit a private cause of action for violations of the FTC franchise rules.²³ Likewise, at the federal level are many laws that both an administrative agency

²² Emerson, *supra* note 10, at 770.

²³ See Debra Burke & E. Malcolm Abel II, *Franchising Fraud: The Continuing Need for Reform*, 40 AM. BUS. L.J. 355, 371-373 (2003) (listing ways in which state laws enforce FTC franchise rules through private rights of action; also citing Robert W. Emerson, *Franchising and the Collective Rights of Franchisees*, 43 VAND. L. REV. 1503, 1509-13 (1990)) (discussing how some state legislatures grant franchisees a private cause of action for any losses to the franchisee caused by the franchisor's failure to comply with certain state laws); Bryan Schwartz et al., *Response to Consultation Paper on Franchise Law*, 8 ASPER REV. INT'L BUS. & TRADE L. 253, 299 (2008) (detailing ways in which states enforce the

and private parties may pursue; while only 18 states permit a private cause of action to enforce violations of the FTC Rule, in the other 32 states a franchise purchaser who relied on incorrect information in the FDD must prove fraud (which usually requires proof of intent to mislead). Yet all states have Blue Sky laws, and the federal securities laws have private rights of action. In comparison, franchise law has no such broad, organized structure. In every state, there is, instead, industry-specific franchise legislation for at least one of these subject areas (and very likely more): auto dealerships, gas station owner-operators, farm equipment dealers, and distributors of wine, beer, or other alcoholic beverages.²⁴ On the other hand, over half of the states have no statute for franchising generally, whether for disclosure, registration, or the franchise relationship itself.²⁵

Relief in state courts is not always obtainable; even when it is legally available, that avenue may still not be practical, as a matter of procedure, state judicial disposition, or, most pointedly, the rule's actual interpretation. On the other hand, a federal case dealing with a violation of the FTC Franchise Rule would be direct, logical, and easier for all concerned to understand as to its procedural posture and its legal basis (e.g., with cases simply (1) pointing to the rule, (2) alleging a violation, and (3) asserting a remedy thereunder).

A private right of action in effect allows franchisees and other interested parties to boost tremendously the effectiveness of the Franchise Rule given that FTC or state agencies, often due to limited funds and staffing, simply cannot investigate many allegations, let alone undertake the even costlier follow-through of pursuing rule violations in court.

The current problem with the FTC Rule and its enforcement is that it is a rule at one level (national), with a scattered set of enforcers, cases, and legal pronouncements at another level (state).²⁶ This dual framework certainly can and often does work.²⁷ However, it is clearly more convoluted and costly than it needs to be, both for the particular litigants and for franchising as a whole. This dual framework impedes the establishment of a sensible set of precedents, as the particular laws, remedies, processes, and standards are in such variance, even when the case

FTC franchise rules); *supra* notes 2-4 and accompanying text (discussing Little FTC Acts found in all of the states).

²⁴ This has long been noted and discussed since the early days of generalized (non-subject specific) franchise legislation in some states, which had one tremendous boom, in over a dozen states in the 1970s, never to be repeated. The industry-specific laws actually often preceded these general laws. *See* Emerson, *supra* note 23, at 1512-1513.

²⁵ Robert W. Emerson & Michala Meiselles, *U.S. Franchise Regulation as a Paradigm for the European Union*, 20 WASH. U. GLOB. STUD. L. REV. 743, 769-771, 769-770 n.161 & 770-771 n.167 (2021) (showing that 15 states have registration and/or disclosure state franchise laws, that 17 states have franchise relationship statutes, and that, with the overlap between those two groups of states, there are altogether 23 states with some form of these franchise states; hence, the conclusion that 27 states have no such general franchise statute, whether covering substantive law or otherwise providing for registration or disclosure requirements).

²⁶ Even when the cases are before the federal courts, the law itself tends to be state law, with the federal court presiding via diversity jurisdiction.

²⁷ If a party is upset with another party's conduct, such as a franchisor's allegedly non-existent or misleading disclosures, and the party has the knowledge, inclination, and means to pursue a case, certainly an action can, very likely, be pursued.

involves, at least in part, the interpretation of something that does not vary – one national rule. With a private right of action, it would be clearer and easier for a party to proceed directly on the matter at hand, and at least some aspects of the judicial decision-making would become more direct and more nationally resolute, hence more manageable. Leading back to the discussion, above, for Question 2, this proposed private right of action would make the disclosure case law more focused on the Franchise Rule – how comprehensible, intellectually coherent and of practical importance are the Items within the rule - thus reinforcing the parties' need to read the FDDs and perform their due diligence.

Currently, the rarity of any FTC proceedings over Franchise Rule violations means that a federal standard, via case decisions, is more hope than even happenstance. For a rule to be before the courts, without the case clutter of extraneous procedural and substantive law matters²⁸ apart from dealing with interpretation of the required disclosures, would surely, over time, help further a national disclosure standard. The linchpin for this development would be a private right of action. A bill, such as the one currently put forward by Rep. Jan Schakowsky of Illinois, “to provide a private right of action for persons harmed by violations of the Franchise Rule of the Federal Trade Commission, and for other purposes,” is a simple declaration of a right to seek actual damages, additional equitable relief, including contract rescission, and reasonable attorneys’ fees and costs.²⁹ The more direct the line between a material violation of the Franchise Rule and a suit against the violator, the better it is.³⁰

No Compelled Arbitration / No Waiver of a Franchise Party's Right to Go to Court

The statistics on arbitration, in terms of the contractual choices of franchisors, indicate the franchisors’ assessment of arbitration. Over time, increasingly franchisors have chosen to include an arbitration clause in the franchise agreements that they have drafted, from under a third of such agreements (31%) in 1993 to well over two-thirds (70%) twenty years later, in 2013.³¹ Another sign of how favorably predisposed toward arbitration are the franchisors is the attitude of franchise attorneys toward arbitration. I have heard these attitudes almost universally expressed by practicing attorneys, both attorneys who represent mainly or exclusively

²⁸ One example of many such drags on the legal process is having a trial or hearing that deals less with the Rule, the alleged non-disclosures, and facts about the franchise while instead considering what may be considered more peripheral issues, such as the franchise applicant’s reliance, business sophistication and other fraud issues. Many state law cases build off an alleged FTC Rule violation, but depend on state common law and procedural concerns rather than, principally if not entirely, a clear-eyed focus on the Rule itself (i.e., on the required disclosures and whether they were provided or not).

²⁹ https://schakowsky.house.gov/sites/schakowsky.house.gov/files/SCHAKO_080_xml.pdf; Schakowsky Introduces Legislation to Empower Franchise Owners, PRESS RELEASE, Feb. 1, 2022, <https://schakowsky.house.gov/media/press-releases/schakowsky-introduces-legislation-empower-franchise-owners>.

³⁰ Nothing would be as upfront as a suit in court based directly on a materially inaccurate misstatement or misdirection with regard to an FDD, or on the failure to make any of the required federal disclosures at all. Presently, that clarity is missing.

³¹ Robert W. Emerson, *Franchise Contract Interpretation: A Two-Standard Approach*, 2013 MICH. ST. L. REV. 641, 695 (2013).

franchisees and those who represent mainly or exclusively franchisors. This sample is, of course, hardly scientific, but it has been, over the years, a steady drumbeat of dozens and dozens of lawyers, with much experience in the field, almost all asserting, quite strongly, that arbitration favors the franchisor, that it is intended to do so, and that it accomplishes that fact.

Here are some of the views I have regularly heard, which I believe the espousing attorneys have a good basis for opining:

1. Even when state franchise laws do try to balance the scales, such as by trying to require litigation in the franchisee's state, the Federal Arbitration Act supersedes the state approach, and that benefits the franchisor.
2. Even if there is a franchise relationship law, it often fails to reach arbitration clauses.
3. Many franchisors overreach, such as with contract provisions that are onerous from the franchisee's point of view.
4. Franchisors occasionally prefer to adopt a different, pro-litigation posture, rather than arbitration, for at least some aspects of their case against the franchisee. These instances show, if not hypocrisy when it comes to some arbitration, at least the fact that franchisors recognize the times when arbitration is not the best answer for them. In these instances, unlike the franchisees, the franchisor can avoid the limiting features of arbitration.

[F]ranchisors may limit the scope of arbitration via carve-outs or simply avoid adopting mandatory arbitration clauses altogether. The most common carve-outs in franchise arbitration are for trademark disputes and claims seeking injunctive relief. A franchisor's trademark "is the lifeblood of the business," and most franchisors will not risk an arbitrator's binding determination that the mark is generic or invalid. Similarly, because injunctive relief can take weeks or months in arbitration, franchisors are interested in preserving access to courts when immediate injunctive relief is necessary. One example is an ex-franchisee's unauthorized use of proprietary information or trademarks, in which case immediate injunctive relief is necessary to stop potential harm to the franchisor. Franchisors might also seek immediate injunctive relief if franchisor liability for the franchisee's acts is at issue.³²

5. Arbitration clauses are often intended principally to discourage franchisees from asserting claims. And franchise agreements usually carve out exemptions from arbitration for the franchisor, but not the franchisee; hence, the franchisor may continue to seek injunctive relief in court while other parties may see their claims limited to money owed (debts).

[M]andatory arbitration provisions can be particularly onerous for franchisees. The arbitration provision is theoretically neutral, but in practice, arbitration provisions tend to favor the franchisor. Arbitration provisions differ from franchisor to franchisor, but

³² Robert W. Emerson & Zachary R. Hunt, *Franchisees, Consumers, and Employees: Choice and Arbitration*, 13 Wm. & Mary Bus. L. Rev. 487, 553 (2022) (citations omitted).

typically the arbitration provision will designate where the arbitration will take place (usually in a location most convenient to the franchisor), limit the timeframe in which a franchisee can assert a claim against the franchisor, and exempt situations in which a franchisor needs to assert its rights. An arbitration provision can also prevent class actions, allow the franchisor to decide the qualifications of an arbitrator, and limit remedies.³³

Because franchisor-franchisee arbitration has been viewed as a less problematic form of dispute resolution - business-to-business arbitration - often the unfairness of contractually-compelled franchise arbitration is viewed benignly. It is actually more extreme for the franchisee than the arbitration to which an employee or a consumer may be subject: “[F]ranchisees are relatively unprotected in the event an opportunistic franchisor exerts its bargaining power. . . . For example, whereas employment and consumer due process protocols require proceedings in a reasonably accessible location, franchisors are subject to no such requirement and may freely stipulate a site unfavorable to the franchisee.”³⁴

QUESTION 4:

Additionally, do these legal remedies address the current concerns about how financial performance data is disclosed?

ANSWER:

As a matter of course, financial performance representations (“FPRs”) should be provided. In fact, they often are given, and the failure to do so can be a strong, worrisome signal about a possible franchise investment. If FPRs are to be required, the Federal Trade Commission is in position to amend the FTC Rule,³⁵ or Congress could in effect do so by amending the FTC Act.³⁶

With respect to the manner and degree of disclosures about financial performance, in general, whether for financial performance data or any other franchise disclosures, both the elimination of compelled arbitration (and opening up greater possibility for parties to go to court) and the ability to take cases under a private right of action for Franchise Rule violations, can provide access to the courts in a way much more suited for and fair to the parties (e.g., the franchisees) than would arbitration or other less “direct” (no private right of action) proceedings.

³³ *Id.* at 544-545 (citations omitted).

³⁴ *Id.* at 563 (citations omitted).

³⁵ See Robert W. Emerson, *Written Statement for Hearing, “Small Business Franchising: An Overview of the Industry, SBA’s Role, and Legislative Proposals,”* March 16, 2022, *U.S. Senate Committee on Small Business and Entrepreneurship*, at 9.

³⁶ 15 U.S.C. § 45.

QUESTION 5:

Would either of these proposals require Congressional action?

ANSWER:*Private Right of Action*

While the FTC's power to regulate franchise sales derives from the FTC Act, which gives the FTC broad power,³⁷ no private right of action is declared in the FTC Rule.³⁸

The original FTC Rule³⁹ was promulgated in 1978 and effective October 21, 1979 pursuant to the FTC's power under Section 5 of the Federal Trade Commission Act⁴⁰ to proscribe "[u]nfair

³⁷ 15 U.S.C. §§ 41-77.

³⁸ A number of holdings find there is no private right of action. *Akers v. Bonifasi*, 629 F. Supp. 1212, 1221 (M.D. Tenn. 1985); *Holloway v. Bristol-Meyers Corp.*, 485 F.2d 986 (D.C. Cir. 1973); *Days Inn of America Franchising, Inc. v. Windham*, 699 F. Supp. 1581, 1582 (N.D. Ga. 1988); *Symes v. Bahama Joe's, Inc.*, Bus. Franchise Guide (CCH) ¶ 9192 (D.C. MD 1989); *Brill v. Catfish Shacks of America, Inc.*, 727 F. Supp. 1035, 1041 (E.D. La 1989); *Mon-shore Mgmt., Inc. v. Family Media*, Bus. Franchise Guide (CCH) ¶ 8494 (S.D.N.Y. 1985); *Freedman v. Meldy's Inc.*, 587 F. Supp. 658, 662 (E.D. Pa. 1984); *Chelson v. Oregonian Publishing Co.*, 1981-1 Trade Cas. (CCH), ¶ 64,031 (D.Ore.1981) [1981 WL 2077]; *Banek Inc. v. Yogurt Ventures USA, Inc.*, (E.D. Mich. 1992); *Layton v. AAMCO Transmissions, Inc.*, Bus. Franchise Guide (CCH) ¶ 9471 (D.C. Md. 1989); *Mercy Health Sys. of Southeastern Pa. v. Metro. Partners Realty LLC*, Bus. Franchise Guide (CCH) ¶ 12,376 (E.D. Pa. 2002); *G&R Moojestic Treats, Inc. v. Maggiemoo's Int'l, LLC*, Bus. Franchise Guide (CCH) ¶ 12,826 (S.D.N.Y. 2004); *Ventimiglia v. AT&T Yellow Pages*, 543 F. Supp. 2d 1038, 1045 (E.D. Mo 2008); *Vino 100, LLC v. Smoke on the Water, LLC*, Bus. Franchise Guide (CCH) ¶ 14,805 (E.D. Penn. 2012); *PT Sak, LLC v. QFA Royalties, LLC*, Bus. Franchise Guide (CCH) ¶ 14,996 (D. Colo. 2013); *Yumilicious Franchise, LLC v. Barrie*, Bus. Franchise Guide (CCH) ¶ 15,725 (5th Cir. 2016).

But see *Bailey Employment System, Inc. v. Hahn*, 545 F. Supp. 62, 71-73 (D. Conn. 1982), *judgment aff'd*, 723 F.2d 895 (2d Cir. 1983) (concluding that while a franchisee aggrieved by the FTC's failure to compel a full disclosure cannot sue under the Federal Trade Commission Act, the franchisee may seek recovery under Connecticut's "little" FTC Act); *accord, La Macaron, LLC v. Le Macaron Development, LLC*, 2016 WL 6211718, Bus. Franchise Guide (CCH) ¶ 15,852 (M.D. Fla., October 24, 2016) (Florida statute); *Akers v. Bonifasi*, 629 F. Supp. 1212, 1221, Fed. Sec. L. Rep. (CCH) ¶ 92771 (M.D. Tenn. 1984) (Tennessee statute); *but see* *Vino 100, LLC v. Smoke on the Water, LLC*, Bus. Franchise Guide (CCH) ¶ 14,805 (E.D. Penn. 2012) (evaluating the claims under the Georgia "little FTC Act" – finding a franchise was not a consumer transaction under the state statute); *859 Boutique Fitness, LLC v. Cyclebar Franchising, LLC*, Bus. Franchise Guide (CCH) ¶ 15,571 (E.D. Ky. 2016) (citing Kentucky Consumer Protection Act and finding the franchise was not a consumer transaction).

And some states simply have not decided whether a violation of the Franchise Rule is a deceptive trade practice. *Yumilicious Franchise, LLC v. Barrie*, Bus. Franchise Guide (CCH) ¶ 15,725 (5th Cir. 2016) (discussing Texas' Deceptive Trade Practices Act).

³⁹ 16 C.F.R. § 436.

⁴⁰ Section 5(a) of the FTC Act provides that "unfair or deceptive acts or practices in or affecting commerce . . . are . . . declared unlawful." 15 U.S.C. § 45(a)(1).

methods of competition ... and unfair or deceptive acts or practices in commerce."⁴¹ In 1995, the FTC began a regulatory review of the Rule, and – after many hearings and commentary - it issued a revised Rule on March 30, 2007. Again, just as in the original Rule, while there had been discussion about including a right of action provision, no such clause was included in the amended Rule. That is especially important because a private right of action has not been found by implication.

It has long been the understanding of the FTC and the courts that the agency cannot, on its own, grant to aggrieved persons (e.g., franchisees) a private cause of action directly stemming from a failure to make the disclosures called for under the FTC's Franchise Rule. Instead, it seems clear that, for the private right of action reform, a simple bill, such as the proposal from Rep. Jan Schakowsky of Illinois, is needed. That bill states that its intent is "to provide a private right of action for persons harmed by violations of the Franchise Rule of the Federal Trade Commission, and for other purposes."⁴²

No Compelled Arbitration / No Waiver of a Franchise Party's Right to Go to Court

I believe this, too, could only be effectively and for the long-term improved (reformed) through Congressional action. Enactment of the Forced Arbitration Injustice Repeal Act (the FAIR Act), or the newest form thereof, would be a way to undertake this improvement.

In your written testimony, you mentioned that brokers and other third parties may be making misrepresentations to prospective franchisees outside the FDD regarding financial performance of the franchisor.

QUESTION 6:

Can you please provide additional details on the nature of this practice and suggestions on what Congress or federal regulators can do to address that problem?

ANSWER:

Online, a prospective franchisee will encounter much information about how to undertake its search for, and evaluation of, various franchises. Brokers or consultants can help provide information and guidance. But accessing such persons is certainly not something one needs to do. As one article concluded, "a franchise broker is optional but it is critical that you hire a

⁴¹ 15 U.S.C. § 45.

⁴² H.R. 6551, 117th Congress (2021-2022) – "To provide a private right of action for persons harmed by violations of the Franchise Rule of the Federal Trade Commission, and for other purposes" (Feb. 1, 2022).

franchise lawyer, consult third-party research, and speak with current and past franchisees.”⁴³ Note that although the FTC Franchise Rule fails to require disclosures about franchise “brokers” it does require that the FDD’s receipt pages state the name, principal business address, and telephone number of each franchise seller offering the franchise.⁴⁴

The practical and legal issues associated with the use of brokers and other third parties has long been a topic of concern.⁴⁵ There are significant problems that loom over any use of this assistance. As an experienced franchise lawyer put it, franchisors could be “legally stuck” with the “uncontrolled” profit projections made to potential franchisees by current franchisees or others.⁴⁶ Of course, our gaze should go beyond the franchisor, looking past the franchisor’s potential for liability stemming from the actions of brokers or others allegedly acting on the franchisor’s behalf; we should focus on the harm to the franchise prospect, that is, the very injury from which any claim against the franchisor would spring.⁴⁷

The problem with franchise brokers or other sellers is that they may be even less susceptible to FTC actions, and the private cases against them often face steep legal obstacles. Franchise brokers and sellers are subject to compliance requirements,⁴⁸ but it is difficult to win suits against

⁴³ *The Pros and Cons of Working with a Franchise Broker*, FRANCHISE BUS. REV., Oct. 21, 2021, <https://franchisebusinessreview.com/post/franchise-broker/>. A franchise broker is, generally, an independent third party who solicits franchise sales and is paid by commissions from the franchisor.

⁴⁴ C.F.R. § 436.1(j) states:

Franchise seller means a person that offers for sale, sells, or arranges for the sale of a franchise. It includes the franchisor and the franchisor’s employees, representatives, agents, subfranchisors, and third-party brokers who are involved in franchise sales activities. It does not include existing franchisees who sell only their own outlet and who are otherwise not engaged in franchise sales on behalf of the franchisor.

⁴⁵ Nicholas A. Bibby, Leslie D. Curran & Richard Kolman, *Pros and Cons of Using Brokers, Developing Agents and Referral Sources*, AM. BAR ASS’N 30TH ANN. FORUM ON FRANCHISING (Oct. 10-12, 2007, Phoenix, Ariz.); J. Mark Dady & Robert A. Lauer, *Franchising 201: Effective and Compliant Use of Brokers and Sales Agents*, AM. BAR ASS’N 40TH ANN. FORUM ON FRANCHISING Oct. 18-20, 2017, Palm Desert, Calif.).

⁴⁶ Mark H. Miller, *You Did What? – Potential Pitfalls for the Franchisor*, FRANCHISE AND DISTRIBUTION LAW INSTITUTE (State Bar of Texas), at 28 (2004) <http://www.jw.com/wp-content/uploads/2018/09/You-Did-What-%E2%80%93-Potential-Pitfalls-For-The-Franchisor.pdf> (referring to franchisor liability for the actions of current franchisees who provide erroneous profit “data” to prospective franchisees in order to receive referring bonuses or other benefits from the franchisor).

⁴⁷ The franchisor’s liability certainly could be a concern, but it only arose secondarily; it is an issue because of the initial harm (deception of the prospective franchisee) occurring in the first place.

⁴⁸ For example, besides some prohibitions concerning the making of FPRs, a franchise seller (e.g., a broker) is generally prohibited from carrying out these seven acts or practices: (1) providing information contradictory to the FDD; (2) using “shill” testimonials or fictitious references; (3) failing to make requested early disclosures; (4) failing to furnish updated disclosures; (5) failing to note unilateral modifications on the franchise agreement presented for signing; (6) using some forms of disclaimers and waivers; and (7) failing to make promised refunds. FED. TRADE COMM’N, *supra* note 5, at 138-143.

them or the franchisors who sometimes benefit from, at best, questionable franchise sales practices.⁴⁹

Absent lawsuits and poor publicity, the franchisor may have little short-term incentive to rein in third parties whose exaggerations or outright lies bring more prospects their way.⁵⁰ This strategy may prove self-defeating, as such prospects who become franchisees and ultimately come to believe they were swindled usually make for poor, disgruntled members of a franchise community. However, that may be a long-term worry, pushed aside if the short-term focus is mainly just growth through sales of franchises, not the sustainability of the network (e.g., through rising franchisee net revenues). Regardless of whether the franchisor's salesperson is a franchisor employee, broker, current franchisee, or some other individual with a financial interest in producing a "sale," the scenario can be the same, even when an FPR is provided, because those are generally couched in limiting accountancy language and disclaiming legal lingo. Besides, prospects likely want to hear the "facts" about profits, even if supposedly for a second time, but this time in layperson's terms. Actually, "since the prospective franchisee is ravenous for estimated profitability data and the franchisor's sales person wants to make the sale so he can [receive a] franchise sales commission[], the franchisor sales person will be motivated to give some profitability data *regardless of the franchisor's written instructions*."⁵¹

The FTC should directly prohibit disclosures outside of the FDD, which are often rendered informally (e.g., merely provided orally) and sometimes offered by credentialed and/or certified third parties. Not only should franchisors not be permitted to share information about the franchise with lenders, brokers, consultants, salespersons, or others if that information is unavailable to the franchisees. For third party franchise brokers, consultants, and any other salespersons who engage in the sale of franchises, the FTC should impose a licensing requirement, including if need be the fiduciary duties one would expect for the financial, personnel, contractual, and other disclosures meted out under the Franchise Rule.⁵² A first step would be to look to state practice for lessons in how franchise brokers or other sellers should be regulated. Two states currently mandate that franchise brokers be registered, New York with a one-time registration⁵³ and the state of Washington annually.⁵⁴

⁴⁹ *ILKB v. Singh*, 20-CV-4201 (E.D.N.Y. June 7, 2021), <https://casetext.com/case/ilkb-llc-v-singh-1>, is a good example of how franchisees often cannot go far with allegations of misrepresentation unless they can be very specific and – hopefully – there are representations made in writing, not just through oral, more disputable, statements.

⁵⁰ See Emerson, *supra* note 35, at 6 & 6 nn.17-19 (discussing the problems associated with use of franchise brokers to produce prospects and, ultimately, sales of franchises); *id.* at 6 n.18 (citing a source, The Franchise Maker, for the estimate that over half (60%) of all franchise lawsuits stem from franchise sales misrepresentation, with franchise brokers often to blame).

⁵¹ Miller, *supra* note 46, at 28 (emphasis added).

⁵² Franchise sellers ordinarily must disclose information to the prospective franchisees with whom they are interacting. See FED. TRADE COMM'N, *supra* note 5. However, one could say that these are transaction-specific disclosures rather than a registration required to be provided to the state, such as for New York and the state of Washington (*infra* notes 53-54 and accompanying text).

⁵³ <https://ag.ny.gov/sites/default/files/form-i-franchise-broker-registration.pdf>

⁵⁴ <https://dfi.wa.gov/sites/default/files/forms/fba.pdf>

The FTC should bring more franchising enforcement actions. If more funding is needed to do that, the funding should be provided as, in the long run, salutary effect of even a few well-deserved and well-publicized cases can more than justify the costs of pursuing these actions. Franchising is such a large and vital part of our economy, yet the legal and practical oversight of it has been unnecessarily restricted by the limited regulatory resources and by a legal framework that only allows the FTC to bring direct enforcement actions for Franchise Rule violations.

What if regulators or lawmakers object to the monetary or other costs associated with heightened FTC enforcement, perhaps arguing that the current rules are sufficient and that competition in the franchise sales market is superior to increased regulatory oversight even if that means some violation of rules goes unpunished? Such an argument may be seen as condoning these violations. Furthermore, there is an alternative. If the existing rules are adequate, but more governmental rule-making or rule-enforcement is viewed as too costly, then why not simply enhance the enforcement of those existing rules (specifically, the FTC Franchise Rule) by allowing affected parties to have a right of action?

One simple measure certainly is in order: A private right of action under the FTC's Franchise Rule. Other laws should also be enacted: (1) A provision protecting from contractual waiver a franchised party's right to go to court; (2) The "SBA Franchise Loan Default Disclosure Act," (S. 2162)⁵⁵; (3) If FPRs under the FTC Franchise Rule's Item 19 are to be mandated, require that this be done subject to the oversight of the agency best suited to the task, the Federal Trade Commission; (4) Provide that all FDDs be placed in an online repository (an online, free-to-the-public forum); and (5) Require that all FDDs be machine-readable (fully accessible for searching and data mining).

Question from:

Senator Marshall

QUESTION 1:

Would a bill to codify a joint employer standard as a person that, "directly, actually, and immediately (and not in a limited and routine manner) exercises significant control over the essential terms and conditions of employment" Be beneficial for independent franchisors?

⁵⁵ See Emerson, *supra* note 35, at 10. The Written Statement and the Hearing on March 16, 2022 also briefly dealt with the issue of whether data was being disclosed by franchisors to facilitate lending for a franchise purchase, but that the data may not have been fully disclosed to the prospective franchisee. This matter may need clarification.

ANSWER:

I believe that bill is the proposed Save Local Business Act.⁵⁶ To me, the key question is whether and how the proposal would benefit not just the franchisor, but also the franchisee and society. Of course, individual franchises, owned and operated by franchisees, tend to be “local.”

A separate issue is whether the *franchisees* are independent contractors (not employed by and/or serving as agents of the franchisor). The franchise parties’ contracts often state that this is the case. I do believe that the law, as applied, typically could, and should, be clearer in this area, whether concerning joint employment or simply any area broadly involving franchising, agency, vicarious liability, and related issues.

The proposed PRO Act would codify the joint employer standard adopted by the National Labor Relations Board.⁵⁷ Two or more employers would be considered the joint employer of a worker if there is shared control of the worker’s essential terms and conditions of employment.⁵⁸ The bill also adds a provision defining independent contractors as opposed to employees, following the three-part rule (the “ABC Test”) implemented in a California court case, subsequently codified and expanded in a California statute (the “AB5 law”).⁵⁹

⁵⁶ The bill would, I understand, amend the National Labor Relations Act and the Fair Labor Standards Act to declare that an employer may be considered a joint employer in relation to an employee only if such employer directly and immediately exercises control over the essential terms and conditions of employment. Of course, as with any such proposal, terms and definitions certainly matter.

⁵⁷ *Protecting the Right to Organize Act of 2021*, H.R.842, 117th Congress (2021-2022), [https://www.congress.gov/bills/117th-congress/house-bill/842/text](https://www.congress.gov/bills/117/congress-house-bill/842/text).

⁵⁸ *Id.* The PRO Act bill, passed by the House of Representatives on June 9, 2021, includes this provision:

JOINT EMPLOYER.—Section 2(2) of the National Labor Relations Act (29 U.S.C. 152(2)) is amended by adding at the end the following: “Two or more persons shall be employers with respect to an employee if each such person codetermines or shares control over the employee’s essential terms and conditions of employment. In determining whether such control exists, the Board or a court of competent jurisdiction shall consider as relevant direct control and indirect control over such terms and conditions, reserved authority to control such terms and conditions, and control over such terms and conditions exercised by a person in fact: *Provided*, That nothing herein precludes a finding that indirect or reserved control standing alone can be sufficient given specific facts and circumstances.”

Id. at Sec. 101(a).

⁵⁹ *Independent contractor versus employee*, CALIF. DEP’T INDUS. RELATS., https://www.dir.ca.gov/dlse/faq_independentcontractor.htm (Jan. 2022). The PRO Act provision in effect adopted California’s AB5 law:

EMPLOYEE.—Section 2(3) of the National Labor Relations Act (29 U.S.C. 152(3)) is amended by adding at the end the following: “An individual performing any service shall be considered an employee

To me, it is understandable for franchisors to worry that the franchise model potentially includes a large number of potential joint employers. To deal with that, though, the franchisor needs to do what has been done for a long time – involve itself in the establishment and maintenance of the overall franchise network and the protection of the system’s trademarks without becoming a second “owner-manager” of the business units. Often, signs of joint employment arise while the franchisor seeks to protect its brand.⁶⁰ Franchisors may try to require the franchisee to meet certain standards approved within the franchise agreement.⁶¹ These procedures are intended to create a uniform experience for customers as well as build brand loyalty.⁶² However, the more the franchisor plays a part in the franchisee’s business, the greater the indicia of a joint employment situation.⁶³ For example, it is one thing for a franchisor to recommend, generally, an operating policy, but quite another to mandate policies directly affecting the franchisee’s employees’ terms and conditions of employment.⁶⁴ Here, one must consider the reality of relationships in which the franchisor often dominates the franchisee:

[F]ranchisees are more likely than arms-length, independent businesses to perceive and respond to franchisor “recommendations” as requirements in light of the franchisors’ immense power over the economic opportunities of franchisees. . . . [For] power imbalances between franchisors and franchisees, decision-makers should consider how economic dependence

(except as provided in the previous sentence) and not an independent contractor, unless—
“(A) the individual is free from control and direction in connection with the performance of the service, both under the contract for the performance of service and in fact;
“(B) the service is performed outside the usual course of the business of the employer; and
“(C) the individual is customarily engaged in an independently established trade, occupation, profession, or business of the same nature as that involved in the service performed.

Protecting the Right to Organize Act of 2021, *supra* note 57, at Sec. 101(b).

⁶⁰ Michael Brennan et al., *Joint Liability for Franchisors: Employment, Vicarious Liability, Statutory and Other Liabilities*, 14 INT’L J. FRANCHISING L. 3, 16 (2016).

⁶¹ *Id.*

⁶² *Id.*

⁶³ John T. Bender, *Barking up the Wrong Tree: The NLRB’s Joint-Employer Standard and the Case for Preserving the Formalities of Business Format Franchising*, 35 FRANCHISE L.J. 209, 211 (2015).

⁶⁴ As a matter of fairness, including meeting the expectations of customers, the more the franchisor, via instruction or otherwise, exercises control over franchisees, the more appropriate it becomes for the franchisor to be viewed as responsible for the franchisee’s actions. This leads to the basic concept of vicarious liability, such as under actual authority or apparent authority. See Robert W. Emerson, *Franchisors in a Jam: Vicarious Liability and Spreading the Blame*, 47 J. CORP. L. (iss. 3 – forthcoming 2022).

affects whether franchisees interpret franchisors' "recommendations" as requirements.⁶⁵

Indeed, courts have long understood that an agreement's simply saying the parties are not joint employers or that an arrangement is merely a license does not keep courts from looking at the realities of the relationship. Courts can, and in fact often do, instead find that a party actually is a franchisee,⁶⁶ and sometimes a court may conclude that a franchisor is a joint employer.⁶⁷ The law should continue to allow for such judicious interpretation, but the proposed Save Local Business Act may stymie further fair and sensible holdings in line with franchising, contracting, and hiring developments. With a cramped view of what would constitute a controlled hiree (i.e., an employee), the proposed Act sets forth a series of terms ("directly," "actually," "immediately," not "limited and routine," "significant control," "essential") that individually and collectively would, rather drastically, skew a judge's or other decision maker's approach against joint employment. It would restrict the continued development of case law and regulations that is in line with the realities of how many franchised business relationships actually operate.

Respectfully submitted,

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⁶⁵ Andrew Elmore & Kati L. Griffith, *Franchisor Power as Employment Control*, 109 CALIF. L. REV. 1317, 1363-1364 (2021) (citations omitted).

⁶⁶ See *Safe Step Walk in Tub Co. v. CKH Industries, Inc.*, 242 F. Supp. 3d 245 (2017). Safe Step Walk in Tub licensed intellectual property to CKH Industries, and Safe Step in turn could (a) compel CKH to alter its business model, (b) set CKH's minimum sales requirements, (c) assist in CKH franchisee's marketing plan, (d) terminate the Safe Step-CKH agreement for CKH's failure to complete mandatory training or not providing monthly financial documents, and (e) prevent CKH from selling any competitor's products. *Id.* at 258. The court found that such controls indicated a franchise relationship, not just a "license" as provided in the Safe Step – CKH contract. It held, "Safe Step has embraced, rather than avoided, the telltale marks of a franchise." *Id.*

⁶⁷ See *Branning v. Romeo's Pizza, Inc.*, No. 1:19 CV 2092, 2020 WL 3275716, at *2-4 (N.D. Ohio Apr. 6, 2020) (noting that a joint employment disclaimer within a franchise agreement and operations manual does not mean there is no joint employer liability).